HOW WELL ARE FLUCTUATING EXCHANGE RATES WORKING?

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OF THE

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HOW WELL ARE FLUCTUATING EXCHANGE RATES WORKING?

WEDNESDAY, JUNE 20, 1973

Congress of the United States,
Subcommittee on International Economics
of the Joint Economic Committee,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:10 a.m., in room S-407, the Capitol Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representatives Reuss and Moorhead; and Senator Ribicoff.

Also present: John R. Karlik, professional staff member; Michael J. Runde, administrative assistant; and George D. Krumbhaar, Jr., minority counsel.

Opening Statement of Chairman Reuss

Chairman Reuss. Good morning. The Subcommittee on International Economics will be in order for the first in a series of hearings on the issue of "How Well Are Fluctuating Exchange Rates Working?"

Obviously, a question like this cannot be answered without defining a basis for comparison. The most apparent such basis is the adjustable peg system that was departed from in August 1971, briefly returned to between the conclusion of the Smithsonian agreement in December 1971 and the summer of the following year, and which progressively eroded until it was discarded in March of this year.

Another possible basis for comparison in the workability of exchange rates would be the system of stable but adjustable rates envisioned by the Committee of Twenty ministers at their last meeting. But since the practical aspects of such a system have not yet been determined, we can only guess about the effects of a shift from fluctuating rates to another regime.

Focusing on the questions (a) of how well fluctuating exchange rates are working and on the related issue (b) of what sort of guidelines should be established to regulate central bank intervention in exchange markets is particularly appropriate now for a number of reasons.

First, despite the float, the dollar continues to slip in exchange markets even after the President's announcement last Wednesday of his new antiinflationary measures. One wonders whether these current disturbances are in fact less disruptive under fluctuating rates than they would have been under previous fixed-rate arrangements.

Second, the point has been made that perhaps floating rates will be with us, if not forever, at least for a good long time. Otmar Emminger, deputy governor of the West German Bundesbank, recently sug-

gested that the world might have to live with floating rates indefinitely in order to keep international capital flows in check. He said:

"It is difficult to see how we can dispense with a more elastic exchange rate system."

A third reason why it is appropriate to focus on these two questions today is that as long as inflation continues at present rates in the major industrial countries, and especially in the United States, fluctuating exchange rates are likely to be a necessity to counteract price increases.

And a fourth reason why it is well to focus on the two questions has to do with the guidelines themselves. The Bank of England recently acknowledged that it had been intervening in exchange markets. And Italian authorities have announced their intention of doing the same thing. These interventions pose the question of to what extent central bank intervention is a desirable means of either dampening exchange rate fluctuations or working gradually toward a return to more rigid rates.

The issue we address in these hearings is whether the floating rate regime, while not necessarily ideal, is the best feasible compromise under today's conditions. We will hear from economists and U.S. officials next week. Today and tomorrow we turn to those who contend day to day with the practical problems raised by fluctuating exchange rates. Today we hear from a group of corporate financial managers. Tomorrow a panel of exchange traders from commercial banks will testify.

Our witnesses are Mr. Walter Hahn, vice president and chief financial officer for Colgate-Palmolive Co.; Mr. Allan Hamilton, treasurer for Exxon Corp.; Mr. Kurt Orban, president of Kurt Orban, Inc., which is primarily a steel importing firm; and Mr. William F. Ryan, director of international finance for Allied Chemical Corp.

Thus we have attempted to get a diversity of viewpoints regarding the practical experience of American firms in dealing with exchange rate fluctuations.

Gentlemen, we appreciate your carefully written statements, which have been given us and distributed. Under the rule and without objection they will be received in full in the record. I would now like to ask each one of you to proceed either by reading the statement, or summarizing it, or going beyond it, in any manner you choose.

Mr. Hahn, will you lead off, sir?

STATEMENT OF WALTER A. HAHN, VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, COLGATE-PALMOLIVE CO., NEW YORK, N.Y.

Mr. HAHN. Thank you, Mr. Chairman and members of the subcommittee, my name is Walter A. Hahn, and I am a vice president and the chief financial officer of Colgate-Palmolive Co. I am pleased to testify about, "How Well Are Fluctuating Exchange Rates Working?" We've given this matter serious thought. We do not claim to be as expert on this subject as some members of the committee or some of the very learned witnesses that will appear before you. But we hope that our practical experience in the day-to-day world of international finance might be useful to you.

In order to understand our position, and our actions in this matter, I should like first to describe certain aspects of our company. Colgate-

Palmolive Co. is a multinational company operating in 52 countries outside of the United States, in principally the package goods industries—such as toiletries, soaps, detergents, personal and health care products. Out of total, corporate, worldwide sales in 1972 of $1.8 billion, slightly over half—or about $950 million—were generated by our foreign subsidiaries. The majority of these subsidiaries conduct their own manufacturing operations—either at company-owned or leased facilities. In almost every case these foreign operations were created to overcome tariff and local government barriers to exports of our products from the United States.

Our international business began 50 years ago and has been built at very little real capital cost to the U.S. operations. In our history, the total amount of capital exported abroad adds up to a mere $15 million—compared to total remittances to the U.S. parent from foreign subsidiaries of more than $400 million, or nearly 30 times the exported capital. The total equity in our international operations was another $150 million at the end of 1972.

The financial management of our international business is, we feel, conservative. That part of our operations which are not financed through internal growth, are financed by local debt. Even where exchange regulations are no barrier, we do not ship capital from one foreign subsidiary to another. Our total foreign debt at the end of 1972 was $50 million—of which two-thirds was borrowed in France, Denmark, Italy, and Mexico, and the remainder in 25 different countries. Furthermore, there is very little export-import trade between our different subsidiaries; each one of which is an autonomous entity, operating very similarly to nationally owned companies in that country.

In the United States, Colgate-Palmolive does not rely much on imports from, or exports to, foreign countries. Our total direct imports in 1972, principally raw materials, were about $13 million—compared to total U.S. raw material costs of some $350 million. Exports of finished goods were about $25 million. By and large, we don't feel that the stability and continuity of these transactions is materially affected by international finance considerations since international trading volume is a fairly small proportion of sales and cost of goods sold and, also, because these transactions are short term and hence have low exposure to currency changes.

Our concern with fluctuations in international exchange rates is based in financial, rather than trade considerations. In this area we are seldom interested in the rate of exchange fluctuations between two foreign currencies. Our paramount concern is with shifts in exchange values between the U.S. dollar and the currencies in which we have major foreign operations. These are principally the German deutsche mark, the French franc, the British pound, and the Italian lira. Changes between these currencies and the dollar have major consequences for Colgate-Palmolive. They affect the final value of dividends and royalties remitted from overseas divisions to New York headquarters. They also affect the company's internal and shareholder accounting for its activities.

A substantial portion of the company's foreign profits are remitted as dividends and royalties. In 1972, this amount was $34 million. The timing of these foreign remittances is flexible. At our option, we may have them sent early or late in the accounting year. The timing is

significantly affected by our judgment on what will happen to the exchange rate in the forthcoming months. If, for example, we felt that the franc was likely to appreciate in value against the dollar, we'd be inclined to postpose transmittal of these funds. If we took the opposite position, we'd want to remit those moneys promptly. Or, alternatively, we might hedge against this possible franc devaluation by selling the franc for future delivery, to an amount equal to the anticipated remittance from our French subsidiary.

Colgate-Palmolive consolidates the accounts of its foreign subsidiaries with its U.S. operations. Accordingly, the interrelationship between the U.S. dollar and several foreign currencies has a significant impact on the amount of our dollar sales and profits, and on the dollar value of our foreign assets. Last year these currency fluctuations worked in our favor. The net gains from foreign remittances and translations added $412,000 to our income. The year before the figure was $1.1 million. Often, though, these fluctuations are detrimental. When Mexico devalued in 1954, we had a $5 million loss, which was not deductible for U.S. tax purposes.

Mr. Chairman, I must at this point admit to some doubts as to how best interpret the events in currency markets during the past year. It has been—especially in recent months—a period of extreme uncertainty and, from our point of view, considerable irrationality in world money markets. The most conspicuous point of irrationality, I feel, has been the undervaluation of the dollar. Fundamental strengths in the U.S. economy have been neglected by market makers. But that is not all: Several fundamentally weaker economies than ours have currencies enjoying what we believe to be unjustified premiums.

This atmosphere of irrationality and uncertainty is compounded by the frequency with which floating rates have recently changed relative values. Unfortunately, we aren't expert enough to know how far floating rates are the cause of this unfortunate market climate, or to what extent the situation would have been fundamentally similar, if all exchange rates operated on more or less at fixed parities.

We are inclined to feel that our financial management was easier and more effective under fixed rates. Colgate-Palmolive conducts long-range financial planning on an international scale. It is an activity we take seriously. This planning has become more difficult because exchange rates are mercurial. Members of my staff are currently working on divisional budgets for 1974. But they are hampered by the difficulties of forecasting what exchange rates will be in effect in 1974. If, for example, in our country a devaluation could be foreseen, then we might now prepare for this event. To offset this devaluation's consequences we could either plan to raise prices, or lower costs in that country.

When currencies were fixed, we found ourselves reasonably able to predict exchange rate changes. We could analyze a country's balance-of-payments figures, its productivity growth, its reserves, and so forth, and come to usually a pretty accurate estimate of where that currency might be headed. We have not been as successful at forecasting the shifts in floating exchange rates precisely because they appear—I should emphasize this is an interpretation only—to have parted company from economic realities.

In this atmosphere we have found it harder to decide on the proper timing of foreign dividend and royalty remittances. Moreover, extreme fluctuations have made currency hedging a more risky proposition.

In conclusion, I'd say that we have no principled objection to either method of rate determination—whether it be floating and flexible, or fixed and pegged. What we desire is a rate-setting machinery that will not foster insecurity and doubt, and which will contribute to world economic growth by being predictably responsive to economic fundamentals.

There should be some point at which a businessman with major international transactions can get his feet on the ground. For this reason, we'd tend to favor reforms that would reestablish fixed parities, with a definite floor and a definite ceiling, in the form of wider bands. Again, I don't know which is the cause or which the effect, but recent floating rates existing side by side with deep uncertainty have demonstrated many imperfections in the international monetary system. I mentioned earlier that we are less inclined to hedge. I suspect that many other multinational companies feel similarly. And I suspect, too, that the forward currency market is extremely thin. This means that an important safety valve has been abandoned. And without the reassurance that corporations can obtain by hedging, world economic progress will not be advanced.

Thank you.

Chairman REUSS. Thank you, Mr. Hahn.

Mr. Hamilton, please proceed.

STATEMENT OF ALLAN C. HAMILTON, TREASURER, EXXON CORP., NEW YORK, N.Y.

Mr. HAMILTON. It is a pleasure for me to be here today and to testify before your subcommittee.

My name is Allan C. Hamilton, treasurer of Exxon Corp. The primary business of the corporation I represent is that of producing, manufacturing, transporting, and marketing petroleum products and its derivatives. We and our affiliates operate in over 100 countries, have assets of $22 billion and net worth of $12.6 billion at year-end 1972, of which 43 percent is in the United States, 39 percent in the Eastern Hemisphere and 18 percent in the Western Hemisphere outside of United States. Our gross production of crude oil and natural gas liquids in 1972 was 5.7 million barrels per day of which 1.1 million barrels per day was in the United States, 1.5 million barrels per day in Venezuela, and 2.6 million barrels per day in the Middle East and Africa. The bulk of our foreign production is traded internationally; virtually all of our U.S. production is consumed domestically. Marginal U.S. requirements are imported and amounted to 0.18 million barrels per day in 1972.

I am pleased to address the questions posed by the committee to this panel regarding the effect of fluctuating exchange rates on trade and investment flows, and to what extent our recent experience may mirror or deviate from future prospects. I plan to answer these questions, first in a rather specific way, and then in a broader sense by outlining issues which both the public and the private sector must define and resolve in order to produce growth in our national and international economies.

The first question to be addressed relates to floating rates—an impediment or impetus to trade and payments?

The substantial adjustment process that the international economy is undergoing makes this an important and difficult question to answer. World trade and payments are being affected not only by a new exchange rate mechanism, but also by an economic shift among nations that more accurately reflects the basic strength of individual countries. As we are all aware, these fundamental and overdue changes have created an unsettled international environment, one, that for businessmen has continued to exist in the brief experience with floating rates. At the same time, since difficulties existed under both a nominal fixed system, as well as a nominal floating system the immediate problem would seem to be immune to, or beyond, any particular system. I shall return to this subject later.

One important exception under current conditions is that foreign exchange markets have so far remained open in the regimen of floating rates, providing at least a basis for international trade and payments, a condition which was occluded on several occasions during 1970–72. Indeed, it is significant, and positive, that markets have continued to function during the recent period of dollar weakness. Since the end of April, as you know, the dollar has depreciated against several European currencies by close to the amount of formal dollar devaluation in December 1971. While not knowing the volume of currencies which crossed exchanges during this period, one could well conclude that had the fixed rate system still been in being the reserve accumulation by central banks consequent to supporting those fixed rates would have been too great to assimilate and markets might well have been closed today.

As for world trade itself, looking at either absolute or percentage increase, no compelling conclusion regarding growth under a floating rate system versus a fixed rate system appears warranted by available data. It is possible we may see some change in the mix of commodities and services involved in trade in the future, but this would, I think, be a fallout of actual changes in currency relationships, which could have been produced by either system. Too, certain commodities may have a different place in the spectrum of world trade, and thereby affect the total, because of factors unrelated to exchange rate systems. Petroleum, which is expected to be imported in larger amounts by some countries (and of course exported by others), is an example.

In the experience of our own corporation, we have not found that floating rates have restricted international trade in petroleum and its derivatives. Payment flows have at times been delayed or inhibited but this was equally true under the faltering fixed rate system. Tqe nature of the petroleum industry, characterized among other thngsi by long-term relationships, means current trade reflects commitments made in a prior period.

Nevertheless, payments for trade have been affected—usually adversely, becoming frequently more costly and more cumbersome. From a business standpoint, a contract to import or export a commodity, which when it is delivered, costs either 10 percent more or 10 percent less than the agreed price loses some of the characteristics of a contract. Such situations have occurred both in the latter stages of the fixed system and in the newer floating system.

One specific instance of the impact of floating rates on payment terms for our own corporation is the recently concluded agreement with the Middle East governments. This newest agreement between the petroleum companies and the OPEC countries concluded June 1, is aimed at making the price of crude oil more sensitive to changes in the value of the dollar vis-a-vis other currencies: prices for petroleum are directly tied to fluctuating exchange rates. The mechanism is an 11-currency index, the movement of which triggers a change in the price of oil, whenever that change is 1 percent or more during a month. The effect of this practice will depend upon the degree of fluctuations around a trend line, and if, in fact, a trend line develops. Month-to-month changes in the dollar price of a primary commodity could prove to be extremely disruptive to companies, as well as both oil-consuming and oil-producing nations. This June 1 agreement supersedes a previous agreement made in January, 1972 which did not contemplate a volatile floating rate situation.

A second area worth comment is that of ship charters. Until the devaluation of sterling in 1967, charter payments were denominated in either sterling or dollars. After that time, dollars became the sole denominator. With the recent dollar devaluations and subsequent float, shipowners have shied more and more away from long-term charters and have tried in some instances to denominate charters in currencies other than dollars, notably Japanese yen, German marks or Norwegian krone. Charters, of course, have resisted this and with neither side willing to take a prolonged currency risk the fall-out has been shorter term charters and increased charter costs. This, of course, is a problem of exchange rate instability rather than of a particular monetary system.

The second question I would like to address is that relating to investment flows and floating rates.

It would be relatively easy to respond to the question of the impact of floating on investment flows by saying we in business are still in the process of assessing the effect of two dollar devaluations, and continued net depreciation of the dollar since the general float. It is also fair to say that for the petroleum industry in the short run, certain investments are made almost without regard to the particular monetary system. This can be the case either because of the physical location of crude oil, or because an investment is an integral part of total operation, one predicated on conditions of an earlier period and necessitating the investment if the entire project is not to be abandoned.

The primary impact of the instability preceeding the collapse of the fixed parity system and of the evolving floating system on investment flows has been through changes and aberrations of the financing process, as opposed to investment itself. In the long run, these two processes—investment and finance—are almost completely interdependent. To the extent that the difficulties of adjustment continue in either the international capital markets or in individual countries for any extended period of time, investment would be adversely affected, both on the side of productive capital investment abroad and on the remittance of dividends to the United States flowing from such investment. The recent proliferation of capital controls underscores this point.

Persistent uncertainty has produced frequent disruptions in the Euro-currency markets. Whereas short-term Euro-dollars have always been available at some price, crises of confidence in the dollar have inevitably been accompanied by a virtual disappearance of a market for new Euro-bond issues. This was again the experience this spring, but it is difficult to assess whether or not the floating rate regime, compared to its predecessor of adjustable parities, has had a specific effect on the situation. Nor have experiments with multi-currency techniques, such as the European unit of account, been able to fill the voids produced during exchange crises.

It is consequently in the area of capital controls on investment that we in business, and I believe the world economy in general, have been most adversely affected. Possibly because our corporation operates in a number of countries of differing levels of development, we have experienced most of the permutations of direct investment control through quotas, negative interest rates, dual foreign exchange rate markets, et cetera. If what I read in the papers is correct, in almost no case have these controls had the intended effect. To the extent that such controls misallocate productive resources, increased costs of investment could well result in loss of real income, not only to investors, but also to the economic system as a whole.

Senator Ribicoff. I wonder if the chairman would pardon me if I would put a few questions to the witnesses?

Chairman Reuss. Please proceed.

Senator Ribicoff. First, Mr. Chairman, I want to commend you for holding these hearings. I am very much impressed by the list of witnesses you have. You have brought here men who must deal with these problems first hand. The significance of their decisions for their companies in these countries is very great. It is also important for the economic health of this country.

What do you four gentlemen see from your own experience as to the future of the dollar, let's say, for the next 2 or 3 months?

Do you see any improvement at all in the strength of the dollar? I have read your statements, and they are excellent. I would like a comment from any one of you gentlemen.

Mr. Hamilton. I will undertake an initial answer to that.

I think that the current situation is not only an economic situation, but it is also a psychological situation; the pressures on the dollar have resulted from a number of psychological factors as well as the fundamental economic factors which have been building up over the years, and the recent pressures on the dollar have perhaps exaggerated somewhat the proper relationships between the dollar and the European countries.

On a fundamental basis I think probably the dollar has devalued sufficiently relative to the European currencies.

Senator Ribicoff. What do you gentlemen, from where you sit, think has to be done within the United States, and by the United States internationally to strengthen the value of the dollar in relation to other currencies?

Mr. Orban. From what we can hear from our suppliers abroad and from our customers and potential customers, everybody seems to be agreed that the dollar is probably a little undervalued at the moment. But for the short run, everyone seems to be pessimistic that for the

next 2 or 3 months if anything it will move down even further, although of course, as Mr. Hamilton said, these things are highly psychological. And some news item may change this thing overnight. In our business we expect a swing sometime in the next few months, but God knows when.

Senator RIBICOFF. I was abroad last December, and last night I had dinner with three foreign newspapermen covering the Brezhnev visit. Whenever you go abroad and you talk to bankers, businessmen, and Government officials, you always find a stronger confidence in the economic strength of this country than I find from Americans. If you go abroad pessimistic about the future of your country you come back more optimistic. There is always this question of why Americans are so pessimistic. Yet we have seen what is happening to the dollar, because of a general lack of confidence. What do you think has to be done specifically internally and externally by this country to strengthen the dollar?

Mr. RYAN. Senator, just to try to respond to that, I don't think anything specific has to be done in the sense, obviously, of another devaluation, effectively the third if you count the floating rate slide we have had in the last 3 months.

As you know, the foreign exchange markets are very fervid markets, they are markets that feed on news. Otmar Emminger once referred to the "nervous young ladies of the foreign exchange market" to characterize their excitement at the least economic news or political news that comes out.

I think what we need to get the dollar moving up again. I think it is pretty clearly agreed it is undervalued at the moment—by everyone except those who are trading it. What we need to get it moving up is a little good news, first on the inflation front, which admittedly is not as bad as Europe, but again we are still the centerpiece of the system, and we can't talk about 7 or 8 percent inflation rates in the United States and expect people to be very confident in the dollar.

Secondly, clearly the Watergate crisis and the overtones that that has for the ability of the Government to straighten out its economic problems is very much in people's minds, so much so that now they are even getting bored with it. And that may account for the little pickup in the dollar yesterday and a little bit this morning.

But good news would do the trick, I think.

The trade figures presumably will be good; we are returning in that direction. But more good news on the inflation front, or some good news, I should say, on the inflation front, and some indication that this governmental crisis, as it is viewed from Europe, is on the way to solution, a clear-cut solution, would be the very best thing, I think.

Senator RIBICOFF. When the President went to phase III, that caused a very adverse affect abroad, did it not, as far as confidence in the dollar?

Mr. RYAN. Yes.

Senator RIBICOFF. Then there was great disappointment with the President's statement last week, was there not?

Mr. RYAN. Right.

Senator RIBICOFF. In other words, tougher economic controls and tougher price controls would make a great difference in your opinion of the value of the dollar?

Mr. RYAN. Yes.

Senator RIBICOFF. Watergate, of course, is going to continue to be an influence whether it is the Ervin hearings or court proceedings. At what stage do you believe this will no longer be a factor, because of boredom, the repetition, and lack of news?

Is it all over after Dean testifies next week?

Mr. RYAN. I think that is impossible to predict. As I say, there is a certain amount of boredom with it now, and of course, a great lack of understanding as to how the constitutional processes work in the United States. This kind of crisis in a parliamentry system presumably would mean an all-out crisis and possibly lack of confidence in the government.

I would say, though, if one wanted a dramatic turnaround in the dollar and a real head upwards in dramatic fashion, it would take some dramatic news of some sort, and a dramatic clarification of the issues. And it is hard to imagine how that might come about.

Senator RIBICOFF. In other words, it isn't the lack of confidence in the American economy, in the strength of the United States, but it is these other, noneconomic problems that we are involved with. Other countries are bedeviled with those problems, too.

Mr. RYAN. Yes; but other countries again are not the centerpiece of the system, and they are all thinking in terms of their currency values relative to the dollar. They are suffering from two devaluations. Who would have thought 2 years ago that the dollar would devalue 25 or more percent?

People who have had their long-range store of value in the dollar as their investment for their long-term needs, et cetera, have been very badly burned. And they are afraid, of course, to take a big position in the dollar again for that reason. And when they see uncertainty—I guess in all markets uncertainty is the big villain. If you are going clearly in any direction, you know what to do. But if you are uncertain, you don't want to take a big position. And nobody wants to be, I think, long on dollars at this point, say, in the European market.

Senator RIBICOFF. What always puzzled me is the effect of the hundred billion Eurodollars in Europe, the Middle East and Japan. Don't the holders have a vested interest in keeping those dollars at a higher value rather than a lower value?

Mr. RYAN. Yes; they certainly do. And that in my judgment at least is one of the main reasons why we have had this crisis. People who had been holding the dollar through confidence—I guess when you come right down to it, the confidence factor is the essence of money when you are holding it for a long term value, not particularly in a trade fashion—but people who are holding Eurodollars to the tune of $50 or $100 billion have been so badly burned by the devaluation that at the least crisis they dump dollars, and they go into the deutsche mark or something else, or gold, or any commodity that presumably will prevent their being burned again. So that these people did not, I don't think, cause the devaluation of the dollar in the sense of deliberately bringing it about.

Senator RIBICOFF. The companies that you gentlemen represent, the large multinational corporations, the multinational banks, American, Dutch, French, English, Japanese, your assets amount to about $268 billion. Your assets are twice as much as the assets of all the

central banks in the world. What worth do you gentlemen place in the fluctuations in the value of the dollar, with your assets?

Mr. HAMILTON. Can I jump in here? Since I will be one of those people on whom the newspapers put black hats.

Senator RIBICOFF. I don't put a black hat on you. But I know that you are speculating. What surprised me was when the dollar took its first plunge, there was only a shifting of about $4½ billion. It surprised me that such a relatively small amount could cause the dollar to plunge so much. I would like your reaction.

Mr. HAMILTON. If I may, I would like to start out with that $268 billion figure, which was a very unfortunate figure to come out in an otherwise excellent report.

Senator RIBICOFF. The U.S. Tariff Commission's report.

Mr. HAMILTON. That is right. The $268 billion figure included all kinds of assets, including some assets of foreign central banks, assets of branches of U.S. banks. If you looked at the breakdown of the $268 billion, it came out that there was $110 billion that was specifically allocated to be liquid foreign assets of private organizations.

Now, that $110 billion figure, I understand, was a figure that was created from a previous number that the Commission had of, I believe about $59 billion of some years ago. They then put on a growth factor and came out to the $100-some billion. And then if you look at the $59 billion figure and consider, are those liquid foreign assets, a very large proportion of that represented inventories and accounts receivable of foreign corporations which are in no sense in the international monetary field liquid foreign assets.

So, the net number would be a much smaller number than that.

That in a sense bypasses your question. I am merely trying to address the $268 billion.

Then we come down to the basic question, what do multinational corporations do in a time of crisis such as we had earlier this year, and to what degree do we flow funds around? I myself can only answer for our corporation. And I have not recently looked at our numbers; but after the crisis, in early February, when about $4 or $6 billion went into Germany, and the dollar was devalued, and there were a number of articles on the multinational corporation treasurers doing evil things, I looked at the number that we had, the values that crossed the exchanges in our operation worldwide during that period. As I recall during the month of January and to the middle of February, which includes this great rush period, our gross transfers to Germany—this is not net but gross—were $1.4 million. And these represented previous contractual commitments, just ongoing business.

Our gross transfers out of Germany during that period, which was really against the flow, and against the speculation, in fact as I recall were $28 million, which also were transfers in the normal course of business that had been set up by the German affiliates.

So when we look at it from the standpoint of Exxon, we did absolutely nothing during that period in the way of transferring what are called liquid foreign assets across currency exchanges which would have contributed to the currency upsets at that point in time.

Senator RIBICOFF. Newspapers keep throwing at you the prediction that by 1985 the Middle East and Persian Gulf States will have about a $100 billion surplus from their sales of oil. Tell me about that figure.

Is there any validity in that figure?

Mr. HAMILTON. I have not seen the latest figure on it. The facts of the situation certainly are that over the next decade to 15 years the primary source of petroleum products in the world will be shifting to the Middle East, and that the marginal source, as can be seen at the moment, the country with the greatest reserve, is Saudi Arabia. And therefore the country with the ability to meet, over this period, the incremental increase in the demand for petroleum products is Saudi Arabia.

Senator RIBICOFF. How does the United States pay for it?

Mr. HAMILTON. This is a question. Last year our import bill, the country's import bill for petroleum products was $5 billion. There are estimates that by 1976 this will about triple to $15 billion, and that by 1980 the import bill will run $25 billion.

Now, this is a gross payments bill. You have to net against that what one would expect these countries to expend, what exports would be created, and so forth. So, the estimates are that in the end really the annual net balance of payments drain on the United States for the import of oil in that later part of the period would be something like $6 to $8 billion.

Senator RIBICOFF. What are they buying? When you look at their economies and their lack of progress socially, and industrially, what do they buy from the United States to allow the United States to have some offset there?

Mr. HAMILTON. This I really cannot answer, Senator.

Chairman REUSS. If the Senator will yield, this subcommittee is scheduling for later this year hearings in depth on the balance-of-payments and international monetary effects of increased U.S. dependence on Middle Eastern oil. I hope that you can concentrate with us then on those questions, although I am delighted that you are opening up the issue, and you just stay with it.

Senator RIBICOFF. First, I want to thank you, Mr. Chairman. And will you gentlemen please pardon me, I have another committee to go to. But I think what you are doing, Mr. Chairman, is so important that to the fullest extent I can adjust my schedule, I will attend as many of these hearings as possible. My thanks to you for allowing me to barge in this way. I deeply appreciate it.

Thank you, gentlemen.

Representative MOORHEAD. Mr. Chairman, I have a somewhat similar problem. May I ask two questions?

Chairman REUSS. You may ask as many as you want.

Mr. Hahn, I think you wanted to come in on Senator Ribicoff.

Mr. HAHN. I am sorry Senator Ribicoff is leaving.

Senator RIBICOFF. I will stay a little longer.

Mr. HAHN. I would like to add a small measure of reassurance on this question of what do the multinational companies do in a crisis.

Colgate also—as I said in the statement formally here—does not transfer currency across national borders. We don't like to take the exchange risks. We never know which way it is going. We have an equity abroad of $150 million. But I would judge $12 million of that is plant and equipment, so we can't even begin to move it. OFDI prevents us from accumulating a lot of liquid assets overseas. We bring back between 65 and 70 percent of our profits each year in

order to stay at peace with OFDI, simply because we had that kind of remittance level in the base years.

So, we can't get away with that. So, therefore, what we leave abroad as retained earnings barely finances our growth.

Chairman REUSS. Thank you again, Senator Ribicoff, for being with us.

Mr. HAHN. As a matter of fact, the Subcommittee on Multinational Corporations of the Senate Foreign Relations Committee has sent out a questionnaire on this, and we are responding to it, liquid assets of a date 90 days later, and so on. So, it will clearly show up.

Chairman REUSS. Mr. Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman.

I want to associate myself with Senator Ribicoff's remarks and commend you for holding these hearings and getting this dazzling panel of real experts on the firing line before us.

I would like to ask first of Mr. Hahn, in your statement you have said that over half of your worldwide sales were from your foreign subsidiaries.

Could you give me the percentage figure as to how many are sales by the foreign subsidiaries to the United States, and how many are sales abroad?

Mr. HAHN. There are no sales to the United States whatever. Our subsidiaries abroad are organized in each of the countries to deal with the cultures and tastes of the people that live there, so they operate as if it were a nationally organized company. We do not bring back any finished goods whatsoever.

Representative MOORHEAD. Let me urge any of you who have a similar picture to let this be known, because we who have to run for election every 2 years are opposed to the argument that the multinationals are jumping over other borders to get lower wages to ship material back to the United States.

Chairman REUSS. Particularly in Pittsburgh and Milwaukee.

Representative MOORHEAD, Those areas in particular.

Mr. HAHN. As a matter of fact, we wouldn't have $950 million worth of business or have brought back $420 million of dividends and royalties if we had not established abroad,. because from what you have judged here this morning, why should a Germany or France or any other country use valuable foreign exchange to import toothpaste and toilet soap from the United States when it can be made over there?

In other words, we wouldn't have any business if we didn't establish there.

Representative MOORHEAD. The other half of your sales, that is, sales of products manufactured in the United States what percentage are exported?

Mr. HAHN. About $25 million into mostly the Caribbean, where we have not established subsidiaries yet.

Representative MOORHEAD. I can't do the math, but it is a very small percentage.

Mr. HAHN. A very small percentage.

Representative MOORHEAD. Now, what I find is the most difficult question, to get the judgment of the entire panel, is what kind of a future should we have in the international monetary world? I notice

in going through the testimony here you talk of the uncertainty of the floating rate. And it was easier to plan ahead when there were fixed rates. But it seems to me then we would go through terrible wrenches when a currency would be out of phase, either over or under valued, and then they would have a great political upheaval, and finally the value would be changed.

At the other extreme is the uncertainty of the freely floating rate. And as one statement says: "it is even worse when you have the dirty floating." But can't we look for a system that is somehwere in between, let's say, the freely floating and the fixed rate on the other hand, where there could be under guidelines by the international monetary fund, permission to intervene or adjustments that could be taken in small increments over a longer period of time so that you would have maybe not total certainty, but not the total uncertainty of unlimited floating?

Do any of you have any comments that would be of help to us on that idea?

Mr. HAHN. May I try that?

Representative MOORHEAD. Certainly.

Mr. HAHN. I don't think that parities can be fixed for all time. Countries like families in the neighborhood are going to advance at a different rate. There has to be readjustment between countries.

Now, that does not necessarily obsolete fixed parities. Fixed parities can be changed from time to time. The flexible rate today is doing perhaps what governments should do on their own. But I think the big problem is, who is doing it in the flexible market today? Is it the people who are interested in sorting out the relationship between countries, or is it the people who are playing the stock market of money? For every seller of dollars there is a buyer. The seller thinks it is going to go down and the buyer thinks it is going to go up. It is the same as Wall Street. So who is in the market today, in the flexible market, doing that job that perhaps they are not qualified or really interested in doing?

I believe that fixed parities can work, once they are properly set—and may I put that in quotes—and with a wider band. We were functioning under a 1-percent band up until a couple of years ago. And then we are functioning at 2¼ percent one way or the other. I don't know what the right amount is. But in my opinion a fixed parity set with some sense of responsibilities, and a wider band, so that it can tolerate some shifts for a little longer period of time and then has to be readjusted, is preferable to the situation we have today.

Mr. ORBAN. May I make a comment on this, too?

Representative MOORHEAD. Yes, sir, Mr. Orban.

Mr. ORBAN. Our business is somewhat differently oriented, in that we mostly presell what we either import or export. And the import-export trade is such that it operates fairly efficiently at rather low profit margins. With the big fluctuations that we have had the swings in the currency really amount to much more than the normal profit margins in the business. And, of course, the result is that the price to the consumer of both the export and import jumps much more, and the inflationary effect of these completely loose rates is really enormous. You may find in the typical importer's or exporter's opera-

tion that his cost of doing buiness might be 5 percent. You have exchange rates that jump around in a few months by 10 percent. So that the cost factors that somebody ultimately has to pay are just enormously inflated by the current complete looseness. And I feel that as Mr. Hahn says, there ought to be some more orderly market in these currencies, certainly from our viewpoint, in the import-export trade. We can only underline that very strongly. What form it is going to take is, of course, another question.

Mr. HAMILTON. I would like to add some comments also, if I may. And certainly the situation which you outlined is a consummation devoutly to be wished. But I think that we have to have the underlying fundamentals present to support a situation such as that. I don't believe that in the near future we are going to have the international confidence in domestic economic policies around the world, or in the ability of the system to control the surplus countries accumulation of balances, or in the area of controlling the massive movements of the Euro-dollars when there are crises of confidence. Until we get a system which is accepted as credible by people around the world, and there is a psychological base as well as an economic base, I think we are going to be in for unfortunate fluctuations, and the gentleman on my left, Mr. Orban, is going to be changing his prices often for a period of time. I think this is the result of the fundamentals of the situation today rather than the result of the desire of anyone to keep the exchange rates fluctuating as much as they are.

Representative MOORHEAD. You know my profession is politics. I think the value of money should not be made by political decisions but by as much as possible the marketplace, maybe within some guidelines.

Mr. HAMILTON. Economic fundamentals.

Representative MOORHEAD. I thank you very much. I have another meeting, and I regret exceedingly that I have to leave.

Chairman REUSS. I know how busy you are. And I am delighted that you could be with us.

Mr. ORBAN. There is one thing that might be interesting.

When the French and Belgians used their dual system for a while where they had one rate for merchandise transactions and another rate for financial transactions, it seemed to work pretty well for them for a period of time. I don't know how this might work for the dollar. But if you look at our total foreign trade, which is about $100 billion of thereabouts, exports and imports, and you contrast that with $100 billion of Euro-dollars just floating around, that might perhaps be worth looking at.

Representative MOORHEAD. Thank you.

Thank you, Mr. Chairman.

Chairman REUSS. Mr. Hamilton, you were about halfway through your statement when we had this, I think, justifiable and very interesting diversion.

Mr. Hahn spoke to me earlier. He needs to get back to New York. Let me say to the other three, Mr. Hamilton, Mr. Orban, and Mr. Ryan, you will certainly be able to leave this hearing room before 12 noon. Does it present a problem to any of the three of you to stay that long?

Mr. RYAN. No.

Mr. ORBAN. No.
Mr. HAMILTON. No.
Chairman REUSS. Then if you don't feel that I am guilty of excessive favoritism, I am going to ask Mr. Hahn a question or two and then excuse him so that he can make his plane.
I would have one question. Some of the questions I had for you have been asked by others. In your statement you implied, at least that is what I gather, that the Colgate-Palmolive is not currently engaged in hedging operations or in extensive hedging operations. You speak of the thin market, and so on.
Mr. HAHN. That is correct.
Chairman REUSS. My question is, when we had fixed exchange rates, the so-called adjustable peg, did you engage in hedging operations to any large extent then? Has there been a change?
Mr. HAHN. This is what we do. In the ensuing year we know what dividends and royalties are coming from European countries. We have seen more devaluations of foreign currencies than we have seen appreciation of foreign currencies in our history. After all, the dollar was never thought to be revalued, so everything has been an appreciation of the dollar.
So we have said to ourselves, if we are getting money from overseas in dollars, let's put a floor under the dollars that we are going to get, because foreign currencies are going to devalue, and therefore we sold the foreign currencies, and bet on the dollar to stay where it was. And that is the only hedging we did.
What we do is to put a floor under the dollars that we get.
Chairman REUSS. One final question.
Mr. Orban a moment ago suggested that it might be useful, at least for the U.S. importers and exporters, to adopt a system like that of the French and Belgians, whereby there are fixed rates for current trade transactions, but a floating rate for capital transactions. That would not help your company, would it? You have testified that, first, you would like something a little more fixed than the present fluctuating rates, and two, that Colgate-Palmolive is heavy on the capital transactions, but does not do much exporting and importing.
Mr. HAHN. We are subject to the two-tier exchange rate now in Italy and France. Our dividends and royalties come out of Italy and France at the financial rate, not the commercial rate. The financial rate is the more expensive rate.
Chairman REUSS. But suppose that the United States were to adopt, in conjunction with other countries, a two-tier system like the French, and I guess the Italians, under which capital transactions are fluctuating, whereas trade transactions are fixed. That wouldn't really help you very much, would it?
Mr. HAHN. No; it would have very little effect, because we do not export capital really. So if there were two U.S. rates, commercial and financial, it wouldn't mean a thing to us.
Chairman REUSS. Mr. Hahn, we are very grateful to you. Have a pleasant trip back to New York.
Mr. HAHN. Thank you very much. If I can answer any further questions I will be glad to do it.
Chairman REUSS. If we think of any more we will send them to you along with your transcript.
Mr. HAHN. Thank you very much.

Chairman REUSS. Mr. Hamilton, please continue your statement.

Mr. HAMILTON. Thank you very much. It has been a very interesting interruption as far as I am concerned.

For years under the fixed-rate system, controls were promulgated by selected countries for varied reasons; in the case of the United States: "To improve the balance of payments and, thereby the dollar's position," or in the case of certain European countries, "to prevent substantial and unwarranted revaluations." Judging by the success or lack of success of these measures, one can thoughtfully imagine the absence of controls, and the degree to which the inevitable adjustments would have already, at this point in time, been worked out.

This is certainly not a group that requires verbiage on the misallocation of resources caused by capital controls. The central question today is what, if anything, would be sacrificed by allowing the free flow of capital, a modus operandi if anything more compatible with floating rates than a fixed exchange rate system.

I would like to comment on the expectations of a floating rate system and whether or not we see the recent experience as projectable into the future, or something different.

There is not a prior reason to reject as unworkable the fluctuating rate system on the basis of its inability to bring order and restore confidence to the international monetary scene. The same can be said for a system based on individual parities. Thus, to my mind, the conclusion that one system as opposed to another could itself accomplish such goals is unfounded. Floating rates have provided no real respite from earlier crisis conditions. They have, given today's conditions, brought a semblance of order to incipient chaos. However, on a day-to-day operating basis we still face (1) maintenance of, in fact proliferation of, controls on capital, (2) instability in the level of exchange rates. Yet I have heard no advocate of freely floating exchange rates include either of these two negatives as characteristics of the floating system. An environment not conducive to manipulation of trade and capital flows on the one hand, and one having a realtime response to exchange rate fundamentals on the other, would in all likelihood make for a workable fluctuating rate mechanism. The same conditions would also, I believe, make a fixed parity system workable.

The problem in letting exchange rates fluctuate with massive speculative flows as opposed to legitimate trade and capital flows, is that one finds oneself saying that to succumb to speculative pressure is better than to counter it, and that trade transactions and Government payments may take their exchange rate cue from the speculative pressures of the day. I question the wisdom of this, and would comment otherwise. And in so commenting I do not fault the floating rate system which has much to recommend it and great appeal; particularly under today's conditions when no one can deny its expediency. But in the end, if massive speculative flows are not to be allowed to rule the day, a dirty float is almost indistinguishable from an adjustable parity system with widened bands.

The success of an international monetary system depends on several criteria, all of which are, I believe, compatible with the goals of both those involved in public policy and in business. They can be briefly outlined—and this responds somewhat to what Senator Ribicoff was trying to get out.

The first is, we need sound domestic economic policy. There is usually little disagreement on the ultimate economic goals: growth, low inflation and low unemployment, high productivity. The crunch comes when the achievement of one goal conflicts with that of another. As far as a monetary system is concerned, what is important is that countries are satisfied with whatever tradeoff they have either explicitly or implicitly made among growth rate, inflation, productivity, unemployment, and exchange rate.

We need an equilibrium rate of exchange, or alternatively, a way to get to equilibrium rate. At the present time we are faced with four kinds of problems in this area. First, the ability of countries to put off rate changes, most notably the surplus nations, but also our own country during years of payments deficits. It may be possible that some international variation of the U.S. Open Market Committee method of noting changes in economic conditions and appropriate action, but delaying publication of such deliberation could be useful.

The second problem, the dollar overhang which developed in the late 1960's, is really a result of protracted rate disequilibrium. The inability of an owner of an asset to sell that asset for value at his discretion creates not only nervousness and market instability, but also fosters lack of confidence in like assets. The problem feeds on itself and compounds as new dollar balances build.

Third, we need credibility of a monetary system. We need the psychological factor that people believe, that it will work, and they are willing to support it.

And last, we need the absence of massive capital flows which are unrelated to trade or investment purposes.

Now, I would like to comment briefly on private capital and public policy mix.

As you have seen, underlying some of my previous remarks is the issue of currency speculation. I'd like to make a few comments in this area.

One thesis, which may be acceptable, is that the recent waves of unrest in the exchange markets represent the natural outcome of the governments of the world treading on forces which they try to ignore. Simultaneously, the holders of funds in the private sector and in some cases the public sector, recognize and are subject to those forces which the governments ignore. Thus the private sector takes over the balancing act the governments should themselves address. In other words, we have crises of default brought on by, first, government inaction in responding to the realities of the international payments situation; and second, a private reaction which steps into the void and recognizes the laws of supply and demand. Ultimately, in the world of money, to every irresponsible action there is an equal and opposite reaction. The magnitude of the problem in the private sector of short-term capital movements is, then, a clear function of the assessment of the private sector of the performance of the public sector and thus the fundamental problem becomes one of exchange rates and exchange rate alterations in a time/rate sense. And, therefore, your committee is indeed addressing one of the most basic questions confronting us all.

I might make the following comments on the destabilizing short-term capital movements which we have seen in the market in the past.

1. In my view, control of short-term capital flows is directly related to the control of exchange rate fundamentals.

2. There is no discrete solution to the control of short-term capital flows if exchange fundamentals create a speculative cast of mind.

3. The sources of speculation cannot be controlled, short of putting all nations' reserves at the disposal of one supranational authority.

4. The best way to control speculation is to create an environment where profits from speculation are not sought.

In conclusion, I would say that the existence of floating exchange rates cannot be said to have facilitated trade and investment flows. To the extent that these flows have been inhibited, it is more a function of crises condition and crises policy, than the nature of either the fixed parity or floating rate system. Both widely varying levels of exchange rates and controls are responsible for inhibiting normal trade and capital flows, with the latter carrying much greater onus.

Conditions permitting the proper functioning of a floating rate system would in all likelihood also permit proper functioning of a parity system, or indeed any other reasonable exchange rate system. Sound domestic policies and a willingness of countries to allow exchange rates to reflect economic conditions are necessary to the smooth functioning of an exchange rate mechanism.

Relatively free rates are and can be a useful technique in the present period, when the establishment of credible and equilibrium rates is a priority issue. Beyond that, the flexibility of governments as opposed to the flexibility of any system per se to allow rates to reflect economic position is the key to continued growth of our international economy.

Chairman REUSS. Thank you, Mr. Hamilton.

Mr. Orban, please proceed.

STATEMENT OF KURT ORBAN, PRESIDENT, KURT ORBAN CO., INC., WAYNE, N.J.

Mr. ORBAN. Mr. Chairman, I would like to thank you for the invitation. I wonder if my prepared statement hasn't already been read, so it would be simpler to dispense with reading it again.

Chairman REUSS. We have your excellent prepared statement, and it has been admitted in full into the record. I have read it, and therefore I accept your gracious invitation to not take the time to reread it.

Mr. ORBAN. May I just add a few comments based on what was discussed during this morning?

Chairman REUSS. Yes.

Mr. ORBAN. It seems to me that what is really needed for a strengthening of the dollar, and stability of the dollar in the foreign exchange markets, is a credible anti-inflationary policy pursued by our Government. Apparently the 60-day freeze was read abroad as really a statement that what we have done in the last year hasn't worked, we are going to start all over again, starting from August 1971. And this is our impression of what people abroad are thinking about the current attempts at controlling inflation. Before that people abroad seemed to be under the impression that we were beginning to do fairly well with it. Certainly the rates of inflation in Japan and the European Common Market seem to be running ahead of ours. But this last drop in the dollar seems to be due really to the impression that we are not really able to control our own house. And this it seems to me is the important thing in getting some stability into this situation.

Chairman REUSS. If the task had been given to you to write the economic message of last Wednesday evening, what would you have proposed?

Mr. ORBAN. I can't really speak for myself as being an expert in this. I am really just relating what people abroad are thinking about our efforts. But the feeling there seems to be that a long-term program, with tighter monetary controls, which seems to be the classical remedy accepted abroad to cool down a boom, plus selective controls of the phase II or phase III type, would have been accepted as a more credible long-term solution.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Orban follows:]

PREPARED STATEMENT OF KURT ORBAN

My name is Kurt Orban and I am President and Chairman of Kurt Orban Company, Inc. of Wayne, Ne Jersey.

I am also the outgoing President of the American Importers Association of New York City, a 52-year old organization devoted to the welfare of the American import industry, with approximately 1000 member firms.

From 1965 to 1968 I was President of the American Institute for Imported Steel of New York City, which was formed in 1952 and has a membership of about 60 companies.

I am not testifying on behalf of these trade associations, but my activities in them have allowed me to learn about the problems of others in the foreign trade field.

Our company is an importer and exporter of steel mill products, special metals, precision machinery, equipment for the wire drawing industry, tires and some plastic products.

We are also domestic manufacturers of wire products for the building industry with plants in Florida, Louisiana and Texas, and we are distributors of a variety of steel mill products with warehouses in New York, New Jersey and Chicaog.

Total sales volume is approximately $120 million.

$100 million of this is in trading, of which currently over 80% consist of imports, the balance being distributed between exports and domestic distribution.

Our manufacturing volume is approximately $18 million.

While we are not multi-national in the accepted sense of branch manufacturing operations abroad, we do have an export/import business in Canada with a volume of approximately $6 million, and we maintain purchase and sales offices in Japan, Korea, Taiwan, Britain, Belgium, Switzerland, France and Greece.

Geographically, our overseas business is split about equally between the Orient and Europe, with occasional business being done in South America, India, Australia and Africa.

I really appreciate the interest of the Committee in hearing about the direct impact of the change in the exchange rate situation from what you might call a "consumer", since the relative value of the Dollar against other currencies is crucial to the operation of a foreign trade business.

Even in our manufacturing operations, we rely on foreign raw materials for at least 50% of our requirements. The same is true of many other independent steel fabricators.

After looking at the list of witnesses and reading some of the earlier testimony, I want to emphasize that I pretend to no expertise in the theory of international money management.

I am restricting myself entirely to the first of the issues to be covered in these hearings.

In fact, my direct experience is limited to *trade*, since our own investment activities abroad have been only very minor and related entirely to establishment of purchasing and sales offices, with annual budgets of well below $100,000.

We do find a lot more people abroad talking about investments of one kind or another in the United States, and hardly a month passes that one of our friends or suppliers does not want to talk about some investment or joint venture in the United States. Obviously, these opportunities look much better to foreigners with a cheaper Dollar and the only thing that seems to bother them is that the Dollar may get cheaper still, in which case the investment may not look so hot four or five years hence.

For us as importers, it was, of course, a much more comfortable situation to have a fixed-rate, over-valued Dollar with which to calculate. It made our imports enormously competitive, even though it just about killed off our export business.

As a matter of interest, I first started in business on my own as an exporter, back in 1941.

However, by 1951, we had become almost completely import-oriented.

From a practical viewpoint, we formerly handled all our transactions in Dollars which people were quite happy to take and to contract in, even for long lead time items, such as special machinery.

During the last 7 years, however, many of our German and Swiss suppliers became increasingly wary about the future of the Dollar and we had to accept currency clauses in our contracts, or purchase in Deutschmarks or Swiss Francs.

Initially, there was no particular problem in hedging these contracts with U.S. banks on a commercial basis and, as far as I know, it was common practice for our other suppliers in Europe to hedge their export sales made in Dollars, with either private or semi-governmental financial institutions. For both them and us this hedging could be done at a reasonable cost and did not impose an appreciable burden on the transaction.

The Japanese invariably sold us in Dollars and did their own hedging in Japan, again at a cost rarely exceeding one percent.

When buying in Korea, Taiwan, India, etc., contracts always were in Dollars and, in fact, they still are.

However, we have found the Indians attempting to raise the price on us on existing contracts when a revaluation or devaluation took place which, in effect, put the burden of the change in the exchange rate on us. Rather than try to take this sort of thing, to Court we always wound up compromising the issue in one way or another but, of course, it is one hell of a way to do business.

Our export sales have been in Dollars right along and continue to be in Dollars, although I can foresee a point, in the event that inflation in other countries should outrun ours, where people will want to start hedging the other way which, of course, would then also complicate the export transactions.

Most of the products which we handle have lead times of no less than 2 months and sometimes as much as 18 or 24 months.

The longer the lead time, the greater becomes the problem with the floating dollar.

On top of the uncertainty of our cost for the goods themselves, the float also makes impossible an accurate advance calculation of Customs Duty for "Ad Valorem" items.

Since the February devaluation of the Dollar and the revaluations of the Yen and the Deutschmark, it has become prohibitively expensive to hedge our exchange for all but relatively short lead time transactions.

We have attempted to overcome some of this by buying spot currencies and prepaying some of our shipments, but while this sort of thing is workable for a few purchases, it is not practical in the normal export/import business which operates somewhat like a brokerage business with narrow profit margins, and which is highly leveraged.

We simply would run out of cash and bank credit in weeks or even days if we had to purchase all of our exchange on a spot basis and prepay.

Moreover, many of the exporting countries now place restrictions on the acceptance of such prepayments, so that this method becomes doubly unworkable.

Moreover, it is always much more comfortable to see the goods before having to pay for them, since any kind of a commercial dispute with an overseas supplier is much easier to negotiate *before* the goods have been accepted and paid for.

The actual expense of buying spot currencies and prepaying is insignificant if the interest rate that one has to pay for borrowed funds and the interest rate allowed by the recipient of a prepayment are roughly the same.

The limitation lies in the total borrowing capacity of the trader and the restrictions placed upon the seller in accepting prepayments plus, of course, the credit risk attendant upon massive prepayments to a large number of suppliers abroad.

It simply adds further hazards to the many normal problems of the foreign trader.

Such prepayments also cause abnormal currency movements, should they be done on a massive scale. The problem is, of course, multiplied for products with long lead times.

Since the February devaluation, the cost of hedging with commercial banks has become practically prohibitive for our type of business, which averages gross

trading profit margins in the area of 5%, with some items being traded with a gross profit of 2% or even less.

On April 24, 1973, for instance, the spot rate on the Deutschmark was 35.33, and the forward quotations for 3, 6, and 9 months were 35.70, 36.17 and 36.45 respectively, which meant that the cost of hedging, on a per annum basis, came to about 5%.

On June 13, 1973, the spot rate on the Deutschmark was 38.05, and forward hedging cost approximately 3.25% on a per annum basis.

For transactions which *can* stand the present hedging costs, these costs are, of course, expressed in the final selling price; and somewhere along the line the consumer is going to foot the bill, since the trader has no place from which to take it.

The effect is inflationary.

In some transactions, we agree with the supplier abroad to split the currency risk. That is initially cheaper but is, of course, risky. Obviously, this can only be done if there is enough profit for both the exporter abroad and the importer here to take such a risk and hope to come out with their shirts on. Again, the cost for this must somehow wind up with the consumer.

On the export side, our customers are, of course, quite happy with the thought that they might have an extra windfall profit when the time comes to pay for the goods which they have bought in Dollars, but since they cannot be sure of such a gain, their selling prices reflect the value of the Dollar as it stands at the time of the contract.

If there is a windfall by the time payment is due, that windfall is likely to stay with the importer abroad rather than serve to lower the quoted price for the American product and thus widen our export market.

This works against the American exporter and the consumer of that export abroad. So, for both our import business and our export business, we would be much better off with a predictable exchange rate.

However, rather than condemn the float as being all bad, I do want to emphasize that we much prefer it to more artificial devices like quotas or surcharges.

Quotas really lead to a great deal of mischief and are enormously expensive to the consumer. They also distort natural economic development, as we have seen it in oil, steel, textiles, and the host of agricultural products which are under various kinds of quotas throughout the world. Ultimately, they are likely to lead to international cartels which might be very nice for the producers, but certainly don't give the consumer a fair shake.

The cost to the consumer of presently existing quotas has been estimated by various authorities as between 5 and 25 billion Dollars per year, depending on who does the estimating.

The surcharge which we experienced from August through December of 1971 was even worse, since it completely distorted the business pattern. It applied to some categories of goods and not to others, thus favoring some sections of the import industry over others, and it was implemented without a proper lead time, resulting in enormous confusion and financial losses for the import industry.

People are *still* suing one another over who is supposed to pay what out of that 1971 surcharge. Ultimately, the bulk of the surcharge was again paid for by the consumer.

Should there ever be a need for another surcharge (and I sincerely hope there won't), then there should be enough lead time given to allow the import industry to adjust, and existing bonafide contracts should be exempted. 90 days should be the very minimum allowed the import industry for adjustment, and I would like to emphasize that the effect on the balance of payments situation would have been very much the same if this had been done in August of 1971, since goods which were either en route or in the final process of manufacture under existing contracts could not be turned around in any event, so that the sudden imposition of the surcharge did not benefit the balance of payments at all. The effect for negotiating purposes with other countries would have been exactly the same if fair warning had been given to the import industry.

As foreign traders, we must, of course, be prepared to live with all kinds of hazards which are not part of the normal domestic business scene.

We do seek to anticipate and to minimize these hazards as much as possible in order to run our businesses efficiently and economically for the maximum long-range benefit of all concerned. The current cost of hedging the exchange or of allowing for exchange rate risks makes this virtually impossible.

I would like to propose to the Committee that serious thought be given to some means of hedgin commercial transactions, both export and import, at a cost

which is reasonable and reflects the philosophy that the value of the Dollar really should not move by more than 2 or 3% per year, in relation to other major currencies.

I would like to suggest that the Export-Import Bank or some other suitable agency should either sell hedges of export and import transactions or guarantee such hedges to the commercial banking system, whereby the cost would be perhaps 1% for a 6-month lead time item and 2% for a 12-month lead time product, pro rata.

Such costs could still be built into the normal import or export transaction without undue strain and would make for a more orderly foreign trade, to the benefit of the American consumer and of our export business.

Chairman REUSS. Thank you, Mr. Orban.

Mr. Ryan, please proceed.

STATEMENT OF WILLIAM F. RYAN, DIRECTOR, INTERNATIONAL FINANCE, ALLIED CHEMICAL CORP., MORRISTOWN, N.J.

Mr. RYAN. Mr. Chairman, my name is William Ryan. I am director of international finance for Allied Chemical Corp.

It is a privilege to appear before this committee as it wisely examines the impact of the floating rate regime on international trade and investment transactions.

Others, I understand, will cover the larger aspects, the macroeconomic aspects of the question. And we are expected to address ourselves to the impact it has had and may have on our own planning, decisionmaking, and international selling efforts.

First, a word about Allied Chemical and its posture in this area. We are a corporation headquartered in New Jersey. And we have three main lines of business: energy, fibers and fabricated products, and chemicals. We employ about 33,000 people.

We sold in 1972 about $1.5 billion totally world-wide. And of this amount exports from the United States accounted for just over $90 million, about 6 percent.

Our imports are primarily raw materials like chrome ore and fluorspar. And they totaled almost $40 million last year. And last year, alltold, our net contribution to the balance of U.S. payments was about $50 million.

Now, in the export area we have an international division which has strategically located sales offices in various parts of the world conducting an aggressive sales program, which I might add has been substantially accelerated in the last 2 years or so, and helped significantly by the DISC legislation, and, of course, by the two devaluations of the dollar.

We sell to about 90 countries overseas all told.

As far as overseas operations are concerned, our affiliates and subsidiaries operate in about 18 countries overseas. We have total assets of about $180 million.

In Europe our principal production facilities are seatbelt plants located in Belgium, West Germany, France, Italy, Sweden, and Switzerland. (Incidentally, Allied Chemical, although a chemical corporation, is the world's largest producer of automobile seatbelt safety systems.)

In Canada, we produce basic chemicals, automobile safety systems, oil and gas.

In Latin America, we are engaged in fluorspar mining, the production of basic chemicals, and oil and gas production. We operate an

oil refinery in Costa Rica which supplies that country's gasoline, diesel oil, and fuel oil needs.

In the past few years we have greatly accelerated our search for energy sources overseas. We are active in exploration and development of oil and gas in the British sector of North Sea, and in Indonesia and Argentina.

We are also, I might add, in the nuclear fuel processing business.

For the most part our production from overseas operations is sold in local or nearby markets. A relatively small percentage of this production is imported into the United States, and that primarily is safety systems in automobiles.

Now, as to the effect of the floating rate regime, first, on our export activity. In general, we have profited by the regime of floating rates in the last 3 months or so. The reason for this is relatively simple. The dollar has been floating down in value during that time, and many of our export sales are price-sensitive. Our overseas customers have been very eager to buy our fibers and bulk chemical products in recent months, rather than Japanese, German, or even British products, largely because the dollar has been a softer currency in which to buy than the yen, DM, or even sterling. So—so far, so good.

But what will happen when the worm turns? The dollar, by general consensus, as I say, of just about everybody except those who buy it and sell it in the foreign exchange markets, is undervalued, and should begin to pick up in value as soon as our trade balance shows more improvement, and as soon as we publish some good news on the inflation front, and generally when confidence is restored at home and abroad in the ability of our leaders to govern.

Suppose the dollar begins to climb, and climbs some 8 or 9 percent in the next 3 months, just as it has fallen 8 or 9 percent in the last 3 months. Obviously, we will then find foreign competition much tougher in our sales effort overseas. When foreign dollars are at a premium of 2 or 3 percent for 3 months, let us say, instead of a discount, against other currencies, then we will doubtless lose some export orders where the competitive margins are slimmer than that. So, we are enjoying the export boom, but we harbor no illusion about floating rates being a panacea for our export business. Far from it. Freely floating rates have introduced a major uncertainty into our export business which is already burdened with enough uncertainty.

I might explain that in the bulk commodity chemical business, at least in our company, when we have periods of brisk economic activity at home as we have now, our export managers have to compete with our U.S. salesmen within our own company for a product which is in short supply to sell in overseas markets. They must be able to demonstrate comparable or better profit yield for overseas sales to these product managers who can very easily sell the products domestically. This is not easy to do in the best of times, what with high overseas freight costs, customs barriers, communication problems, and longer collection periods involved in export sales.

When you add to these difficulties an additional 3- to 5-percent hedge cost which a foreign buyer might have to crank into his costs in a period of dollar strength, you reduce our profit margin by that amount. So you can see why the export manager might have difficulty in getting that product from the product manager to sell abroad.

So, a system of reasonably stable exchange rates is thus far more conducive to a sustained export sales effort in our particular lines of business.

We appreciate the desperation that led the governments of the free world to the two devaluations of the dollar and the floating rate system and another devaluation, in effect, in recent months, and we have enjoyed the short-lived export boom that has in part resulted from that. We would be dismayed, however, to think that these governments might think that the problem is solved and that floating exchange rates can now bear the burden that central banks could no longer bear through their intervention to preserve stable exchange values, and the consequent changes in their official reserve positions that resulted.

In this connection those of us who are trying to export might well ask, what are central banks and governments for? Few of us would argue today that governments do not have a central role to play in regulating the pace of national economic activity, the level of employment, and the rate of inflation. Have governments abandoned the function of averting unemployment in the economic export sector, of abating domestic inflation by encouraging an appropriately high level of imports, and appropriately low level of exports? Most assuredly the European nations that depend on exports and imports more than the United States does have not, and we will see more and more official intervention by these countries in exchange markets to maintain appropriate exchange rate values. Clearly, as Congressman Moorhead pointed out, there should be agreed-upon principles and guidelines for such intervention in the new international monetary arrangements, so that we may avoid the game of competitive "dirty" floating which is potentially just as destructive as the competitive devaluations of the 1930's. European businessmen and officials are already accusing the United States of a deliberate policy of competitive devaluation in its refusal to intervene in the foreign exchange markets to ease the economically unjustified, as they feel, decline of the dollar since March.

Turning to the investment process, in our foreign investment decisionmaking the primary factors are marketing, long-range supply, and, of course, profitability. And since it is unpredictable in the long run under any system, the foreign currency aspect is treated as a relatively small element of the profitability factor.

I might say that in recent years our strategy with regard to financing investments abroad has changed somewhat, and quite probably is in the process of changing right now. Until the late 1960's, a rule of thumb in financing overseas investments was to borrow a good portion of the required capital in the host country, so that the erosion of asset value that would take place when that foreign currency depreciated or devalued would be offset by a similar erosion of the liability, the indebtedness, in that foreign currency.

Starting about 3 years ago, with the foreseeable loss in the dollar's strength, this rule, at least in our company, was reversed. Since there was a revaluation opportunity in foreign investment instead of a devaluation risk, at least in the European countries, it made sense to send in as many dollars as possible to create foreign assets and minimize foreign debt, so that we could ride up on the increasing value

of the assets and the cash flow. The companies that adopted a policy of borrowing very heavily in the European currencies had obviously great difficulties when the devaluations of the dollar took place, and had substantial writeoffs. If we assume, coming to the present strategy, that the dollar is at a low point and is bound to go up, again it may make sense, from a financial strategy viewpoint, to borrow heavily in the local currencies again and have just the reverse picture.

Since the generalized floating rate regime came into effect in March, we in our company have had only one major foreign investment decision in process. It involves a world marketable commodity, oil. So the erosion of sales values through depreciation of currencies has not been a particular consideration. If it had been, I honestly feel that the long range uncertainty of a floating rate system would have been no more of a problem than that of a fixed rate system. Both systems are equally uncertain in a 3-, 5-, or 10-year decision framework. If anything, a floating rate system has at least the benefit of avoiding massive currency changes through devaluations that are sudden and highly visible, and therefore, very painful. The gradual erosion of asset values through currency depreciation does not raise red flags of concern with management the way one-shot losses through official devaluation do. And this is as it should be, because in a properly functioning floating rate system, of course, the changes in the values of the two currencies should reflect more or less continuously the relative rates of inflation and true purchasing power on the two countries.

Potentially far more deadly to decisionmaking in the investment area are capital and exchange controls. Those of us who believe that the free flow of legitimate long-range investment capital represents the best road to development and prosperity for all nations have been dismayed by the thickening web of exchange restrictions and capital controls of recent years. In our own country, the FDI regulations, the "103" guidelines and the IET barriers turned back the clock. And the Europeans, of course, have joined in the restrictions game.

We realize these exchange and capital restrictions were felt to be necessary in the case of the United States because our poor balance of payments performance had led to a critical loss of confidence in the dollar overseas. The problem was exacerbated, and I would maintain, co-caused, by the vast overhang of dollars owned outside the United States which was generated entirely by years and years of Government spending abroad in excess of the huge surpluses earned by the trade and investment activity of the private sector. While justified economically in the post-World War II years, this excess spending in my judgment was not so justified in the 1960's, and is, I think, or was, the root cause of the problem.

There was no problem with this overhang of dollars abroad as long as foreigners could have confidence in the wisdom and integrity of the economic leadership of the United States. Indeed, the overhang provided the basis for the flourishing of a control-free Euro-dollar market, a truly international capital market of very significant dimensions. But when this confidence was lost, in large part as the result of our entanglement in Vietnam, foreigners who had their savings in dollars began to fear for their safety (and how right they were!) and to dump these dollars on foreign exchange markets for other curren-

cies or gold at the mere mention of a worsening of inflation or poor trading figures from Washington. And thus began the series of currency crises that culminated in the Smithsonian agreement in December 1971, and the second, perhaps unnecessary, devaluation of the dollar, and then the floating rate system.

In summary, Mr. Chairman, my own feeling is that a floating rate system is helpful to us in our price competitive, price elastic, export activity, as long as the foreign currencies are rising in value. But it will hurt us when the dollar again reasserts its strength. We would, therefore, prefer a system where currency values are reasonably stable, and the costs of forward cover on trade transactions are predictable. In our investment decisions floating rates should be no more unpredictable in the long term than fixed rates were. And if they lessened the likelihood of large devaluations and exchange controls, they would even be preferable.

It seems to me the lessons, if there are any, to be learned from this recent rather bitter history are essentially these.

First, the United States must deserve the respect it wants for its currency. This requires the prudent management of its domestic and overseas affairs with due regard for the good opinion of our now very powerful world neighbors.

Second, the Free World nations, the less-developed countries, and even the Socialist countries, have a great deal more to gain from the free flow of capital and trade than from its restriction. And they should avoid restrictions on trade and capital movements at all cost.

Third, more frequent and smaller adjustments in currency values are less disruptive to trade and investment than massive and shocking devaluations. But there must be agreed-upon principles and guidelines among countries so that the floating rates are orderly and do not degenerate into competitive depreciations and trade wars.

I feel international trade and investment can flourish under either floating or fixed exchange rates provided governments are prudent and cooperative in establishing a harmonious set of objectives in regard to inflation and domestic economic activity which translate into a fair framework of exchange values among nations.

Thank you, Mr. Chairman.

Chairman REUSS. Than you, Mr. Ryan.

All of you gentlemen have, to say the least, had some criticism of floating exchange rates. Mr. Ryan has probably been, momentarily, at least most relaxed about them. But other witnesses say they have caused considerable problems.

Let me ask this question. It has been asserted to this morning that the big troubles of the dollar abroad in the last month, troubles which have seen the dollar depreciate to a value where many people think that it is now undervalued, is primarily the consequence of, first, the political aspects of the Watergate and, second, our failure to cope with this country's economic problems, principally inflation.

I would think from our testimony that all three of you gentlemen agree that these two causes are an important part of the depreciation of the dollar in the last month.

Mr. HAMILTON. They are a part, but certainly not all.

Chairman REUSS. In your business, for instance, oil, there are plenty of other factors——

Mr. HAMILTON. I think Mr. Emminger in his speech also brought out one of the basic factors in this respect. And that is the fact that the European countries have reached the saturation point on buying dollars, and having this create a monetary base which gives them more internal inflation. They have just reached the point where they are unwilling to make such purchases from an internal monetary control standpoint. And this has been part of it.

Chairman REUSS. Well, given those two or three or more causes of the present low esteem of the dollar internationally, my question is this. In this morning's discussion aren't fluctuating exchange rates being made to bear part of the onus of a particularly unfortunate current situation for the United States? If there were no Watergate, if there were no bad management of the domestic economy, particularly with regard to inflation, if this saturation of Europe with dollars that Mr. Emminger has described were not part of the current record, isn't it quite possible that fluctuating exchange rates would be working quite well? Wouldn't we have avoided a dollar that many people think is undervalued, and wouldn't the fluctuations have been much more moderate? Thus, wouldn't the pain have been less for all of you gentlemen and our companies?

In other words, isn't this a particularly unfortunate time in which to evaluate the effect of fluctuating exchange rates? If we had pre-1971 fixed-exchange rates, wouldn't we, as Secretary Shultz said the other day—and I agree with him—be in a worse pickle? Wouldn't we be seeing drastic efforts on the part of our Government and perhaps others, to defend the dollar, the squandering of billions of taxpayers' dollars in the defense, and then a crash when it didn't work and we had to devalue by a good amount anyway?

Mr. Ryan.

Mr. RYAN. Mr. Chairman, I think a couple of those conditions you could describe as special and perhaps transitory, but I don't think you can put the dollar overhang in that category and say, well, if there were no overhang. If there were no overhang it would be to my mind a much different ball game entirely. That is a major fact, I think, of the situation. There is the dollar overhang, because the dollar was for so many years, is now and will be the transaction currency. So those dollars are there. And to me it seems the central problem is the degree of confidence of people in holding those dollars, continuing to hold them, using them for transactions, and using them in the Euro-dollar market as an investment currency. I think you have the two functions of money at odds there, as a transaction medium, and as a store of value.

So you can't remove that piece of the action.

Secondly, the fact that we had a second devaluation so hurriedly after the first one, and in the minds of many, including myself, rather unnecessarily, given the circumstances, has given rise to a feeling among people in Europe and around the world, among people who hold dollars, that the U.S. dollar is not a reliable currency. You can see one devaluation where an adjustment among currencies was arrived at at a major international meeting, the Smithsonian Agreement. And an 8-percent devaluation was not that world-shaking. But to have the next crisis come along and have an immediate, almost ad hoc solution of another devaluation of the dollar I think is very shocking to the

people who own this overhang. And even without perhaps the special transitory features that you mentioned in the equation in the last 3 months, I think we would have still a great deal of nervousness in Europe about the solidity of the dollar, and people are not willing to take very long positions in the dollar. So you would have a selling bias, I think, in the market, even without the special features you mentioned.

Chairman REUSS. How would you have avoided that second devaluation? One way, of course, that I would have preferred would have been not to have a second devaluation. That seemed to flumox the rest of the world unduly, just let the dollar depreciate by whatever amount it was going to depreciate without putting any imprimatur on it.

Would that have been to your mind better?

Mr. RYAN. I think it would, a temporary floating regime, if you will. And then I would have opted for a declaration on the part of the Fed that they would be a definite participant in that market. Certainly that was what the Europeans wanted, and they were offering very adequate credit lines for that purpose. That would have been my solution to the problem at that point. I think perhaps we should have taken the stand that currency values by and large are properly realined in concert with the Europeans, and we will, generally speaking, hold those values. We may temporarily go to a floating rate regime. And we could even temporarily have widened the bands, or something of that sort. But generally we should have said: It is our judgment, and we want the market to acknowledge this, that currency values more or less are properly alined at this point.

Whether indeed the United States had in mind that the first devaluation was only part of the way that we should have gone, I don't know. My own feeling is that we went far enough that time and could have maintained an orderly foreign exchange market situation through temporary devices.

Chairman REUSS. How could we, though? The poor Bundesbank was being flooded with 6 billions of dollars in 1 week in February, and they were getting fed up. I personally think it would have been a disaster if the Fed and the Treasury had gone in heavily for intervention.

Mr. HAMILTON. It would have been like Great Britain in 1967, it would have just been frittering away funds at that point.

Chairman REUSS. And in the end not working.

Mr. HAMILTON. That is right. And I find it hard to rationalize that the second devaluation was unnecessary really when we look at the fact that since the end of April there has been further depreciation of the dollar, 11 percent, I think, vis-a-vis the European currencies.

Chairman REUSS. We can't change history, though it is interesting 4 months afterward, looking back at it.

Let me get to the next question suggested by what we are discussing. Here we are with fluctuating exchange rates. Your testimony is that they bothered your companies in one degree or another, in the case of Allied Chemical mostly in the future rather than in the present.

One way of stabilizing matters is of course intervention by central banks, including our own. What thoughts do you have on what you would like to see our monetary authorities do?

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I should tell you perhaps that I take a very dim view of the ability of mortal man to figure out what exchange rate is right. And while I don't like the excessive speculation which has occurred, I would try to leach it out by attacking what we have just agreed are the causes:

One, the Watergate. Well, let Mr. Nixon come forth and tell the whole story. That will lay the matter to rest.

Two, the bad economic policies that we are pursuing. Get rid of those and pursue some good ones. Tax a little more, spend a little less. And tell Mr. Burns to create a little less money than he has in the last few months. And get a more rational system of price-wage controls than the one announced here today.

As to the dollar overhang which you both pointed out, that is one hell of a problem. I on this subcommittee have been urging consolidation, make an offer to the holders. Say, let them turn in what they don't want to the IMF and let the IMF give them its obligation, and we, the United States, will then pay this interest to the IMF. That is one way out of the problem. And we have got to do something about it.

So I would think this is a better solution than to have mortal men try to second-guess the market by intervening.

But I want your views, and not mine.

Mr. ORBAN. I would think, from what Mr. Ryan said, and also the experience of our company, and the members of our importers association, that if there were some way of controlling the cost of the hedging, both for exports and imports, this would probably be a cheaper method of having a more orderly flow of foreign trade than an intervention which would have to cover not only trade but also the financial transactions and the speculation that goes on.

Chairman REUSS. You made a very interesting suggestion there, Mr. Orban, that the Ex-Im Bank sell currency hedge positions for exports and imports. I think that is a suggestion that has to be explored. The first thing the exploration should do is to calculate the costs and benefits. Will American taxpayers pay out more through the Ex-Im Bank than American consumers would have to pay for higher prices for imports and some reduction in export sales? I don't know. But your suggestion deserves serious study.

Mr. ORBAN. Our experience in our trading is, since the two devaluations that the imports that we buy and the people that we know in the export-import trade buy have become so much more expensive that a good many of them are beginning to shut off or to reduce substantially in volume. And I feel that once the current overheated situation ends, this will be even more pronounced.

We are also finding that things that we couldn't export for years we are able to export, and we have started a small export program, and we have only sold a million dollars thus far just as one company. This has been going on for a little over a year. These are new exports that didn't exist a year ago. If other people are doing the same, which I presume is probably going on, we may find that with the new exchange rates there will be a very substantial swing in the trade balance quite unexpectedly.

Chairman REUSS. You have made a responsive and constructive suggestion. You have said that in effect, "Yes, Congressman Reuss, I agree that massive intervention by mortal man, the Fed and the Treasury, may be a poor idea. Let's get around the problem by a Government-guaranteed hedge program, perhaps through the Ex-Im

Bank. If the Government can guarantee home mortgages through the FHA, why can't it guarantee hedges and reduce the price of hedges through the Ex-Im Bank?" That deserves examination.

Mr. Hamilton.

Mr. HAMILTON. I would like to say that I agree with your position on this, Mr. Chairman. I think that when looking at an intervention in an exchange market, you have to look at what you expect to accomplish. And presumably if you are intervening you are trying to lend some stability to the market. And that says that you have concluded that this will lend that stability. The fundamentals of the situation today, I think are such that you cannot say that intervention will lend this stability. And, therefore, you cannot conclude that intervention is the thing to do. There are other things to do before that, it seems to me.

Chairman REUSS. Along the general lines?

Mr. HAMILTON. Along the lines which you have outlined, and which I think I also outlined in my talk here.

Also I would like to add that I did not mean to give the impression in my statement here that I feel that the floating rate system is the incorrect system at the present time. I think it is the correct system at the present time.

I think if we had tried to stick with the parity system through today, as I mentioned in my statement, the market might well have been closed by now for inability to operate. It is just that I feel it difficult to say that one system in the long run is better than another system, until you settle the fundamentals. And then when you set the fundamentals, you can almost say that one system will work as well as the other system. It is very hard, I agree, setting the fundamentals. And as Mr. Emminger said in his talk, he can see floating for some time to come, but in his very last paragraph he also foresees the day when he hopes we can go back to a fixed parity plan.

Chairman REUSS. As one of you said in your statement, it doesn't really matter very much whether you have a fluctuating system with rules for clean intervention or a relatively fixed system with a widened band, crawling peg and rules of adjustment. That comes to very much the same thing.

What really matters is, first, that you don't go back to the old brutally fixed system, and, second, that you attack the fundamental problems—political uncertainty, and inflation.

Mr. RYAN. Mr. Chairman, just to be responsive to that, I don't discount the value, I think, as you do, and perhaps others, of intervention. I don't say necessarily that intervention or the nonintervention by the Fed in the last 2 or 3 months was the wrong course necessarily. That is a large question, I guess. But I say this. The intervention by the Fed is, I would say, a very important part of the market mechanism. You say, mortal men at the Fed can't make decisions of that sort. The whole market is mortal men. And the market wants to know what governments think. And it knows what governments think in any floating rate system by intervention. When you are dealing—I am sure the traders will mention this tomorrow—in the New York foreign exchange market and you see a trend going in currency, one of the first questions is, what is the Fed doing? Is it in the market or not?

In Europe the same thing: Is the central bank in or not? Is the government a participant in the market that particular day? Does the government think a particular thing?

Now, governments are alleged to be rather weak against multinational corporations. But remember, we are all—in the aggregate we may have vast resources, but we are all very unitized, if you will. We are dealing to protect and enhance, perhaps, our own individual positions. So we are not banding together and saying: OK, today let's sink the dollar or let's sink the deutsche mark or something of that sort. Governments have a very concentrated power which they can exercise through the foreign exchange market. And it seems to me the market wants to know in a floating rate system what the government thinks.

It knows now in Italy what the Government thinks; namely, that the lira has gone just far enough and they don't want it to go any lower.

They know in Canada what the Government thinks; namely, that they want a reasonably close parity between the Canadian and the U.S. dollar for large governmental objectives.

I think the market wants to know sooner or later what the Fed thinks here. I can see the Fed having stayed out as part of its overall negotiating posture, that we are going to let this dollar really slide very, very far before we come back in perhaps as part of our negotiations and say, well, all right, if you will give certain things, you Europeans, then we will agree finally to come in and help by intervening in the exchange markets.

My view is that the intervention of the Fed is part and parcel of the cooperative, harmonious objective, or a set of objectives, that all of us eventually have to agree to. Any mechanism, any mechanistic approach to the problem, is going to fall through the crack. It is just not going to work. In other words, you can't just devise a machine that is going to work perfectly. The foreign exchange market represents the interface of various national economies. And if you have one moving at a very rapid speed and the other at a slow speed, the foreign exchange market is going to show that discrepancy. So you have got to have reasonably agreed objectives, reasonably harmonious objectives among the nations and, I would add, reasonably agreed parameters, if that is the word, for intervention by the central banks of those countries to keep things more or less in phase, not to control the market, not to dominate the market, but to be a very, very important—the single most important—influence in that market. That would be my view on the intervention question.

Chairman Reuss. We, of course, don't have reasonably agreed ground rules for intervention among the world central bankers, or anything like that, do we?

Mr. Ryan. That is right. But we are in a transitional period, quite clearly, we are in a negotiation period. We are trying to rearrange the world trading rules in fact, we are trying to come up with reasonable objectives in the international monetary area, quite clearly. That is the task of the Committee of Twenty, and of the governments that stand behind them, to come up with agreed objectives. And I think when they emerge, and it is clear that governments will take reasonable steps within that framework, then the problem of the overhang, I would say, will disappear. People then would be very confident to

hold their dollars, invest them, trade them, et cetera, for the foreseeable future. I don't see any need to mechanically "resolve" the overhang problem if people have confidence in the currency they are holding. And there is no guarantee that they are going to be more confident in a piece of paper issued by the International Monetary Fund which they don't really understand and which may produce a fixed rate of interest which is not nearly as exciting as the Euro dollar rate of interest.

Chairman REUSS. But a devaluation-proof piece of paper that is denominated in a bundle of currency or some kind of weighted average is what the monetary doctors are talking about and what seems to me essential.

Mr. RYAN. Which, if I may say so, would be rather incomprehensible for an investor.

Chairman REUSS. This is just for central bankers, as discussed.

Mr. RYAN. Just for the official holdings of dollars.

Chairman REUSS. And they can understand anytime.

Mr. RYAN. Except the workings of the foreign exchange markets.

Chairman REUSS. A very interesting discussion, and very helpful. We started these hearings with a few preconceived ideas of our own, of course. But we wanted answers from experts on the firing line, and we have certainly gotten them. And I am most grateful to all of you gentlemen. I did promise that we would adjourn by 12 noon, and it lacks 1 minute of that.

So, with our thanks, the subcommittee will now stand in recess until 10 o'clock tomorrow morning in this room.

[Whereupon, at 12 noon, the subcommittee recessed, to reconvene at 10 a.m., Thursday, June 21, 1973.]

HOW WELL ARE FLUCTUATING EXCHANGE RATES WORKING?

THURSDAY, JUNE 21, 1973

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL ECONOMICS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:05 a.m., in room S-407, the Capitol Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representatives Reuss and Brown, and Senators Javits and Percy.

Also present: John R. Stark, executive director; Jerry J. Jasinowski, John R. Karlik, and Richard F. Kaufman, professional staff members; Michael J. Runde, administrative assistant; and George D. Krumbhaar, Jr., minority counsel.

OPENING STATEMENT OF CHAIRMAN REUSS

Chairman REUSS. Good morning.

Today the Subcommittee on International Economics continues its investigation into the impact of fluctuating exchange rates on international trade and investment and into the guidelines that should be established to regulate and coordinate central bank intervention in exchange markets.

Yesterday we heard from a group of corporate financial officers. This morning we have invited a panel of exchange traders from commercial banks to give their opinion. We will hear first from Mr. A. Robert Abboud, vice chairman of the board of the First National Bank of Chicago; and then from Mr. John Hawes, the first vice president of the Bankers Trust Co.; and Mr. Robert F. C. Leclerc, vice president of the Continental Bank International, Mr. Hector Prud'homme, general manager of Brown Bros. Harriman & Co.; and Mr. Alan Teck, vice president of the Chemical Bank.

Gentlemen, we appreciate the very compendious and helpful statements which you have prepared and handed us. And under the rule and without objection they will be received into the record and printed in full in our hearings.

I would now like to have you proceed in any way you choose. I am sure all of you will not want to read all of your statements, but suit yourselves how you summarize or read or go beyond it.

Mr. Abboud, please proceed.

STATEMENT OF A. ROBERT ABBOUD, VICE CHAIRMAN OF THE BOARD, FIRST NATIONAL BANK OF CHICAGO

Mr. ABBOUD. Thank you, Mr. Chairman.

It is a great pleasure to be here today and I congratulate the committee and its chairman on their objective approach to this very important issue.

There are no hard and fast answers to economic and financial problems. At best there are only tradeoffs between alternative and often conflicting objectives.

All of us bring our own experience and the attitudes of our own constituencies to these matters.

I am associated with a bank which has 339,000 savings accounts and I believe is the largest savings institution under one roof in the world. Thus my opinions are reflected by the attitudes of these savers who, by and large, tend to be of moderate means and for whom inflation is a real problem.

Second, I have spent practically all of my business career in banking and international finance. The experiences and impressions obtained thereby also underlie my judgment on the monetary situation.

Recently, it has been fashionable to criticize the Bretton Woods system. Obviously, it had its faults, one of which ultimately caused its destruction, and while I don't suggest a return to Bretton Woods, I think it only fair to acknowledge the very real benefits it gave us. And these would include: An almost exponential growth in world trade; a restoration of currency convertibility on a worldwide basis unparalleled in history; and most significantly, the development of a worldwide capital market, the Eurocurrency market, which was and continues to be a significant capital pool.

But the Bretton Woods system is now past. The priority, in my opinion, is to establish the objectives and requirements for a hoped for future system. Acknowledging my own bias, I would set down the objectives as follows: Confidence in the future value of the dollar and a way to insure against the risk of change; free and unrestricted currency convertibility and negotiability; and convenience, mobility, and maximum access by every country to a worldwide capital market which would insure the maximum possible supply of consumer goods at the lowest prices.

With the breakdown of Bretton Woods, each nation or region evolved a course of international monetary conduct which ministered to its own particular needs at the moment. The aggregate of these ad hoc courses of action constitutes the present nonsystem which is really a system of floating rates for regional blocs.

The argument in favor of floating exchange rates is national autonomy in the conduct of domestic objectives, but to seek national autonomy in the conduct of domestic objectives is not without a price. The price of national autonomy is a more disorderly futures market for foreign exchange: Under the present arrangement the cost of hedging in the future market has risen substantially, and is less available, the price has also reduced worldwide liquidity, caused by a proliferation of barriers to the inflow and outflow of funds from the European currency market, and another cost is additional foreign exchange controls and a severing of the ties between the domestic and the international currencies.

Capital flows stimulated by the prospect of exchange rate changes prompt controls. The purpose of the controls is to segregate funds within a particular jurisdiction from the same funds in the international marketplace. This segregation results in different interest rates and different permitted usage. In effect it constitutes a severing of the ties between the domestic and international currencies.

Under a floating rate system the central bank does not have the responsibility of intervening directly. But recent experience shows that intervention does in fact take place. It takes the form of controls which restrict convertibility to move capital, and even goods, as we have just seen from the President's recent message.

And finally, the price of national autonomy is also greater fluctuation in domestic prices of internationally traded goods.

The exchange rate of a country's currency—and I would underscore this—relative to others, is probably the single most important price in existence for that economy, because it affects the domestic price relationships for a wide range of goods. Mr. Kemeny of Dartmouth College stated that the key to a complex system is to find that gland or pressure point where delicate adjustments will radiate and magnify throughout the system. Mr. Friedman taught us that the rate of growth in the money supply is one such gland. I respectfully suggest that relative change in the exchange rate is another such gland at least with respect to inflation or deflation.

A devaluation, actual or de facto, raises the cost of imports in the same manner as a tariff. It also provides a protective umbrella for price rises on competitive products of domestic origin. Moreover, by enhancing the competitiveness of domestic production in international markets, exports increase and the scarcity of goods in the domestic marketplace is further aggravated, and in some cases this scarcity, in and of itself, prompts Government intervention and controls.

In reality, national autonomy is permissiveness to pursue political objectives of momentary advantage which may prove inconsistent with the longer term mutuality of interest which any meaningful trade agreement requires. National autonomy is really an attempt to avoid discipline. Such an avoidance is inconsistent with a trade agreement which by definition imparts burdens and imposes responsibilities on both parties. What good does it do to reduce tariffs 15.2 percent on widgets in return for a 25-percent reduction in foreign tariffs on agricultural products if currency changes the next day change the trade—weighted impact of the concessions granted by either side. It seems to me that changes in tariffs and other barriers to trade and changes in exchange rates are two sides of the same coin.

I have indicated my own biases and ordering of priorities earlier. They include currency convertibility, freedom from controls, and markets that respond, insofar as possible to the operation of market forces. In achieving these ends, however, it is obvious that we must have a monetary system that does not impose intolerable and unacceptable strains on its members or it will break down. To this end a mutually agreeable code of conduct of behavior is essential and it seems to me that we might usefully offer to negotiate on all facets of a new monetary agreement.

These would include parities, responsibilities, and penalties—this might be an extension and expansion of the scarce currency clause of the original IMF agreement.

We should be willing to surrender some national autonomy or self-interest to obtain a joint undertaking and we should support the dollar internationally. Such support would provide the following benefits: Confidence and orderly markets would be restored; domestic inflation in the United States would be dampened; the capital markets in the United States would strengthen not only the stock market but also the market for long term fixed income securities; and improved relations with other countries that such support would provide, may brighten the chances for meaningful trade and monetary negotiations.

We must also make a determined effort to combat inflation at home. And without a greater measure of price stability in the United States, it will be virtually impossible to restore confidence in the dollar. To achieve such stability we should: Adopt and follow appropriate anti-inflationary fiscal and monetary policies on a consistent year-in and year-out basis.

We must boost productivity and maintain the competitive position of U.S. industry. This ought to be our priority long-term objective. To achieve it we will have to find some politically acceptable method to restrain total demand and divert a larger proportion of our national income into capital investment. Such a program cannot be implemented in an environment of highly restrictive monetary policy. Therefore, it would appear that greater emphasis should be placed on the fiscal and exchange rate mechanisms to control inflation so as to permit a more expansive monetary climate for the long-term capital investment that we need so badly.

We must also remove bottlenecks and inefficiencies in production. This is not just a question of asking the assembly line worker to be more attentive. It's rather an entire system of values and choices which we must confront honestly. For example, do we want cheap energy or clean energy? Do we want efficient lower cost production or pollution control? Do we want lower cost production or product safety? Do we want lower cost production or military leadership? All of these issues involve important tradeoffs and should be faced squarely.

We must also spur research in high technology areas and probably redirect some of our efforts away from military and space related concentration toward consumer oriented areas.

In conclusion, in my opinion we ought to support the dollar and move toward comprehensive negotiations on a new monetary system. And we ought to re-examine our domestic priorities and adopt the policies and disciplines required to attain them.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Abboud follows:]

Prepared Statement of A. Robert Abboud

Priorities and Purposes of a New International Monetary System

I. Introduction

It is a great pleasure to be here today and I congratulate the Committee and its Chairman on their objective approach to this very important issue.

There is always the temptation, on occasions such as this, to preach, to write too much and to talk too long. Just like everyone else, I have made the same mistake.

There are no hard and fast answers to our economic and financial problems today. At best, there are only trade offs among conflicting courses of action, each of which ministers imperfectly to any particular objective with undesirable

repercussions on the attainment of others. The evaluation of these alternative courses of action depends greatly upon the biases with which one approaches the issue and the constituencies we each choose to serve.

In the best of all possible worlds, there would be neither inflation nor disequilibrium in trade between nations. Currency parities could be fixed or flexible and it would make little difference. Perhaps trade and investment between nations would be completely free, and completely flexible currency parities would reflect this in continuous minute adjustments. But reasonable men differ even in how they perceive this best of all possible worlds, so it should not be too surprising that we also differ in both our perception of the present and far less ideal situation and in our advocacy of remedial measures.

II. THE CONSTITUENCY WITH WHICH I IDENTIFY

With the Committee's indulgence, I should first like to acknowledge my own biases and the constituency with which I identify.

Our Bank in Chicago has more savings customers than any other bank in Illinois. As you know, we are a unit banking State and thus have only one office. But in this one office, we have 339 thousand savings accounts and total savings of approximTtely $1.7 billion. I believe we are the largest savings institution under one roof in the world.

Our savings customers, by and large, have moderate incomes, do not have access to money market investment certificates such as treasury bills or large denomination CD's, and regard their savings as a form of security for the future, the down payment on the house, college education, the future wedding, or security after retirement. Moreover, for these savers (because of their moderate incomes) the food budget tends to be a fairly large percentage of their total income, as is the rent budget, clothing, transportation and other everyday necessities, so that inflation or depreciation in the currency is a hardship.

Secondly, I have spent all of my business career in banking and international finance. By good fortune, this involvement with business and international finance occurred at a time when American commercial interests were expandng all over the world. I participated in the expansion of our own bank from no overseas offices in 1959 to 36 overseas offices in 24 countries at present. I witnessed with great pride the development of new markets for American products abroad, the training and skills that the establishment of American industry imparted to foreign nationals, the upgrading in the standard of living, and finally the increased level of communication and understanding that seemed to occur whenever Americans began to do business in a foreign land. These convictions underlie my judgment on the monetary situation and may help explain my selection of objectives and courses of action I favor.

III. PAST ACCOMPLISHMENTS AND FUTURE OBJECTIVES

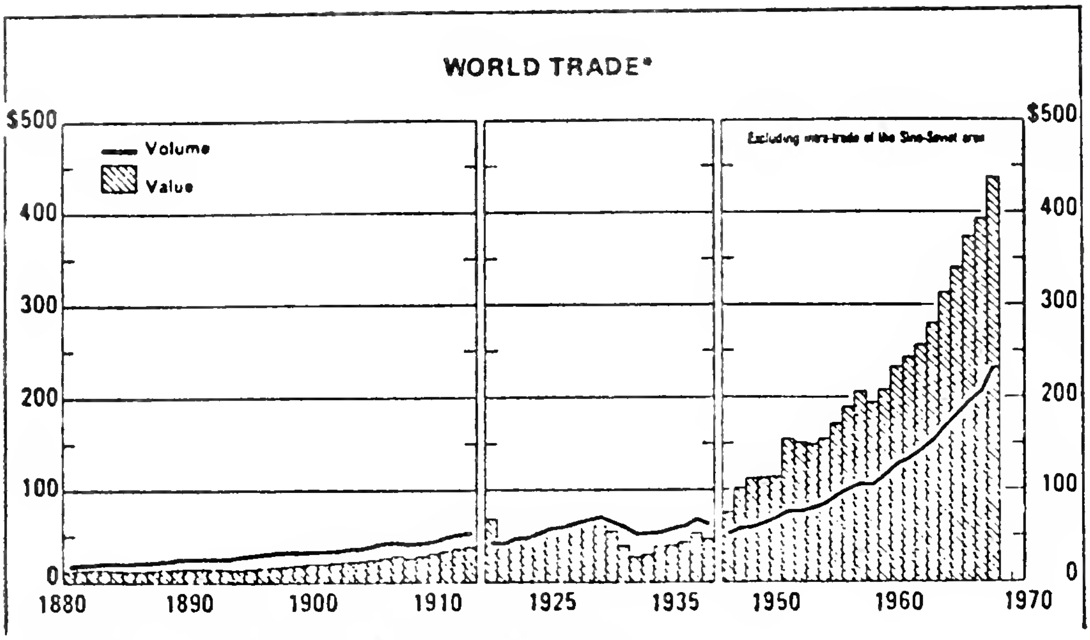
Recently, it has become almost fashionable to criticize the Bretton Woods system. And there is no question but that the Bretton Woods system had serious flaws which ultimately caused its downfall. The most important one, of course, was the failure to provide an appropriate remedy for weakness in the key currency, the United States dollar. And we can understand why the founders of the system never considered this eventuality in 1944. The United States was the dominant economic power in the world with most of the productive economic capacity and almost all of the free world gold reserves, and weakness in the dollar was inconceivable at that time. But after twenty-five years this did in fact occur and because the system had no remedy, it collapsed.

A. The Past—The Bretton Woods System

While I do not advocate the resurrection of the Bretton Woods system in its original form, it seems to me that we could do much worse in the future than we did during the past twenty-five years.

1. Growth in World Trade

The Bretton Woods system stimulated the greatest growth in world trade that the world has known. The enormous expansion in world commerce facilitated a worldwide rise in production and living standards.



Source: Bank for International Settlements, Annual Report, 1969, p.77

* Value in billions of 1969 U.S. dollars
Volume in 1928 prices

2. Restoration of Currency Convertibility

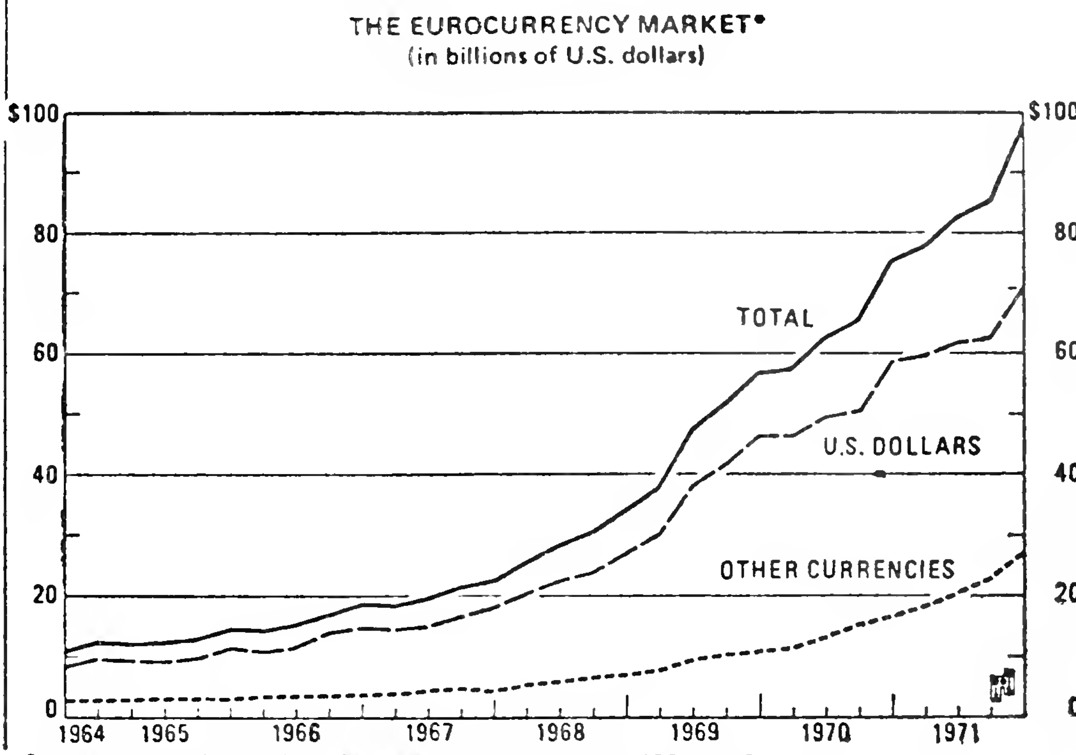
The Bretton Woods system enabled a restoration of currency convertibility on a scale not seen since WW I. Between World War I and World War II the world marched backward into a proliferation of controls. Today it is easy to forget that, in 1946, when the Bretton Woods system first became operative, there were foreign exchange controls in almost all nations other than the United States. You recall that travelers could not take money out of Canada, England, France, or almost any other country. Importers and exporters required license and exchange approval. Foreign investment had been brought to a halt during the preceding two decades by controls, currency disorders, and the war. But by 1966, twenty years later, foreign exchange restrictions had been virtually eliminated in almost all of the major countries of the world. Travelers, importers, exporters, investors, anyone could freely convert dollars to Deutsche Marks, Deutsche Marks to Pounds Sterling, Pounds Sterling to Canadian Dollars. And I personally believe that free convertibility among currencies was, in large measure, responsible for the growth in trade, investment, and general worldwide prosperity.

3. Facilitated Capital Flows And Fostered World Capital Market

The Bretton Woods system also facilitated capital flows from areas of surplus to areas of deficiency and fostered the creation of a truly international capital market—unshackled, flexible, and responsive to the needs of borrowers and lenders.

The assumptions of the system were that if the parities between currencies remained relatively stable, the flow of capital would be stimulated by the prospect of higher yields and better investment opportunities as long as currencies were convertible. In a relatively stable system, a dollar-based investor would be less reluctant to make a long term capital investment denominated in Deutsche Marks or Francs because long term hedge contracts would be available at a reasonable price. And so, capital began to move, not only to the developed areas of the world but also to the developing countries.

I believe we would all agree that these were impressive achievements. Our problem today is what system or mixture of policies will produce comparable results in the future.



Source: Bank for International Settlements, Annual Report, 1972, p. 148

* External liabilities in foreign currencies of banks of 8 reporting European countries

B. Priorities And Requirements For The Future

The objectives we seek in a new system and the relative importance that we attach to them are obviously matters of opinion. As for my own, the key objectives would be a stable purchasing power for the dollar, and the free exchange of goods, investments, services, technology and ideas with nonresidents in order to assure ample supplies of goods and services in the United States at the lowest possible prices.

I believe that the dollar should be as good in Germany, Switzerland, Japan or anywhere else as it is in the United States and that it should be freely and readily convertible into any other nation's national currency. I believe, moreover, that convertibility among currencies is also the key to trade and investment.

And for these purposes, the essential ingredients of any existing or new monetary system would be:

1. Confidence In The Future Value Of The Dollar And A Way To Insure Against The Risk Of Change

We are fortunate in this country to have the world's largest and most broadly based capital market. The range and breadth of the capital market includes not just equity securities but also bonds, notes, preferred stock, commercial paper, and much more. At home our capital market worked because the unit of account, the U.S. dollar, was accepted as a worthy storehouse of value. Foreigners also had confidence in moving from their national currencies to dollars and if they sought insurance, they could get it through a foreign exchange contract at a reasonable cost. And if Americans sought to go from U.S. dollars to a foreign currency, they too could get exchange protection at a reasonable cost. In my opinion, the whole system rested upon confidence—confidence by savers and investors in the future purchasing power of their savings or investments and a combination of confidence and insurance in the foreign exchange markets. Confidence stemmed from many factors—the presumption that the U.S. would maintain the purchasing power of the dollar within generally tolerable limits, that foreign governments would convert their currencies into dollars of stable purchasing power and that the U.S. government, somehow, in some hazy, indefinable way, stood ready to convert dollars into gold. And it doesn't really make any difference whether dollars or gold made sense as a standard. It is a

fact, whether rational or not, that the system inspired confidence both by savers and investors and by exchange insurers. And any viable new system must inspire the same confidence. In other words, the psychology of the market is as important and, on occasion, of greater importance, than the intellectual composition of the system.

2. Free And Unrestricted Currency Convertibility

Since Bretton Woods, the dollar has been the world's primary transaction currency. And this has been a great advantage to all Americans. Investors, both foreign and U.S., denominated their transactions in U.S. dollars. Exporters and importers, both U.S. and foreign, denominated their transactions in U.S. dollars. Central banks denominated and maintained a large part of their reserves in U.S. dollars. Tourists travelled the world over with their U.S. dollar traveler checks without question about their ability to use them. U.S. dollars would buy Deutsche Marks or Yen or French Francs or whatever because ultimately the central bank of each of these countries was obligated to buy the dollars with its own local currency. No other currency had this unique advantage. And why was this important?

Because it insured negotiability anywhere and everywhere. Let's assume, for example, that a U.S. tourist travels abroad with $1,000 in U.S. dollar traveler checks. She arrives in Frankfurt, Germany and presents those checks for conversion into Deutsche Marks at the teller's window of the Commerzbank. When the teller buys the checks, the bank is long dollars as the cash account on its balance sheet includes the $1,000 in U.S. dollar traveler's checks. The bank will process the checks for collection and with the proceeds can either:

(a) keep the $1,000 in its "due from" account with its U.S. bank correspondent;

(b) invest the $1,000 in the U.S. capital market or the Eurodollar market;

(c) or, if it has reached its aggregate limit in dollars, sell them to someone else for DM or Yen or Francs or gold or whatever.

And therein lies the problem. What happens when everyone reaches their aggregate limit in U.S. dollars and there is no one available at that precise moment to buy the Commerzbank's $1,000? Heretofore, the central bank provided a market of last resort. Under the present system, the central banks are not so obligated and there is no so-called buyer of last resort. Under the present system in the situation hypothesized, one of two things might happen:

(a) the Commerzbank will refuse to buy any more U.S. dollar traveler's checks;

(b) or the rate at which the dollars might be purchased will be lowered to a point where a buyer can be found.

And thus negotiability at a fair or economic price is rendered uncertain. And this scenario is not just for tourists. It also applies to investors, importers, exporters, pension and trust account managers, and every other individual or manager of assets. The willingness to hold U.S. dollar assets is largely dependent on the ability to convert those assets at any time (should there be a need for such conversion) into any other currency at a fair and economic price.[1] And if such convertibility (which in turn means worldwide negotiability) cannot be assured, the asset manager will properly select some other unit of currency. And this may in part explain the recent popularity of Swiss francs and gold. It may also be noted that the central banks of the European Economic Community are obligated to buy each other's currencies within established and publicized limits, thereby providing last resort facilities for inter-country financial transactions among this group.[2] If a similar arrangement is concluded in the Pacific with the Japanese

[1] It is contrary to experience to argue that the price for paper currency or traveler checks will be allowed to drop to any levels dictated by the market place. When the international price drops sharply and is out of line with the assumed domestic economic value, nations heretofore have almost always imposed an embargo on the export of bank notes (i.e. paper currency) to stop large outflows. Italy presently has a measure forbidding convertibility of Italian bank notes on capital account to stop the illegal outflow of capital from Italy. And there are, of course, numerous examples in the immediate post World War II period and in developing countries with chronic inflationary problems.

[2] The technical aspect is fairly simple. Before August 1971 Banque de France stood ready to buy or sell dollars against French Francs from any bank at given exchange rates which corresponded to the floor and the ceiling between which the French Franc was allowed to be traded. At the present time, Banque de France uses the same technique but only vis-a-vis the Belgian Francs, the DM, the Guilder and the Danish and Swedish Kroners.

The credit aspect can take numerous forms but the most popular ones are the swap arrangements and the credit lines with other central banks. Since June 1, 1973, France, West Germany, Belgium, The Netherlands, Denmark, and Sweden have unlimited swap facilities with each other but the settlement must be made at the end of each month and in European units of account.

The settlement aspect is, of course, the heart of the matter. Settlements must be made in a reserve asset such as gold, SDR, major convertible currencies or units of accounts.

Yen as its peg, individuals and asset managers will be drawn increasingly to hold assets in non-dollar currencies simply to provide for future flexibility.

Therefore, I believe that any monetary system requires convertibility of the U.S. dollar (and thus worldwide negotiability) if we expect our citizens and business managers to keep the bulk of their assets dollar denominated.

3. Convenience, mobility, and maximum access by every country to a worldwide capital market insuring the maximum possible supply of consumer goods at the lowest prices

The best currency is generally the least restricted currency. It holds its value in terms of other currencies and can be transported from place to place at will and without regulation. The issuing nation is not fearful of exporting the currency because the competitiveness of its goods and services in world markets is acknowledged and hence the claims (i.e. the national currency) on those goods and services pose no overhanging liability which cannot be readily extinguished. And the nation importing the currency is not fearful because as Gresham's Law states, it is not a question of bad money coming in to drive out the good money but rather stronger money coming in to upgrade the local, relatively weaker money. And this is the stuff that makes a worldwide capital market.

We witnessed that precise evolution in the 1950's. The dollar was the strong currency, convertible, freely mobile, and in great demand everywhere. The result was the Eurodollar market, a progressively increasing capital pool, responsive, flexible, and universally utilized. And subsequently it became a Eurocurrency market wherein the ingredients were not only dollars but Sterling, DM, Francs, Yen and other currencies. And the currency transactions of investors moving from investment opportunities in one jurisdiction to investment opportunities in another created a broadly based futures market which made cover for hedging readily available and reasonably priced.

The resulting capital market benefited both the industrialized and the developing nations. Roads, mining projects, factories, housing developments, agricultural reform, and many more were financed through the Eurocurrency market. And the key to the system was the link provided between currencies by the U.S. dollar which was universally accepted as a medium of exchange. Any currency that could be converted to U.S. dollars in the Eurocurrency market was eligible for use in France, Italy, Brazil, Australia, or anywhere—because these nations were required by mutual agreement to accept U.S. dollars as the "key currency".

The 1950's and the early and middle 1960's were the years when capital investment flourished on a worldwide scale—prompted not by fear or the lure of currency speculation but by the quest for higher yield, i.e. natural resource development, production closer to sources of supply or markets, availability of cheaper labor, proximity to more efficient transportation, and many other market oriented reasons. The exponential growth of trade in goods and services resulted in a larger quantity and variety of goods for the consumer at lower prices. It also resulted in the need for often painful reallocations of resources, as some industries in many countries, including our own, lost markets to lower priced foreign goods. In effect, however, the consumer benefited and the more competitive industries gained ground relative to those who were less efficient. This is not to say that unfair advantage in the form of foreign subsidies and other encouragements to foreign manufacturers did not exist. They did and still do exist. But by and large, the monetary system of the 1950's and early to mid-1960's favored expansion, efficiency in production and hence the consumer.

Beginning in the 1960's the situation began to change. First came the controls on the U.S. dollar, i.e. the Interest Equalization Tax, the Voluntary Foreign Credit Restraint, Foreign Direct Investment Controls, and proliferating reporting requirements. Later in the 1970's, particularly after August 1971, with the demise of Bretton Woods, other nations adopted progressively more restrictive controls against the influx of U.S. dollars from the Eurodollar market.

This trend toward controls restricting entry of Euro-currency funds into local markets has now reached alarming proportions. A typical example is that of the Federal Republic of Germany which until recently has been the world's foremost proponent of free trade and investment.

On March 1, 1972, the Federal Government passed a law by which the central bank was authorized to introduce a cash deposit requirement on almost all types of non-bank borrowing abroad. The cash deposit ratio was set at 40 per cent with a DM 2 million exemption. This exemption was decreased to DM 500,000 and the ratio increased to its legal maximu 1 of 50 per cent in June 1972. On January 1,

1973, the exemption was further reduced and is now DM 50,000. Still not satisfied with the results, the government increased the legally permissable ceiling of the cash deposit rate to 100 per cent.

In June 1972, a shield was put up blocking another way by which money could enter the country. Effective immediately, the acquisition by non-residents of domestic bonds payable to bearer or order became subject to authorization and in February this year the same restriction was introduced for the purchase of shares by non-residents as well as for borrowings from abroad.

These measures were taken in the name of protection against "pernicious capital flows." It was done in conformity with Gresham's law, i.e. keep out the allegedly "bad" money or it will soon undermine the "good" money. But the net result, of course, was to reduce the serviceability of the world capital market. Germany is not the only country to impose such controls. They are proliferating around the world. More restrictive and prevalent controls will curtail the usefulness of the capital markets. If you can't get Eurocurrencies in, what good are they? The purported liquidity of the market becomes less meaningful. Declining liquidity and the worsening climate for trade and investment will give established industries and manufacturers protected havens. Restricted access to markets, reduced competition will hamper growth, efficiency and the potential rise in standards of living through higher prices of goods and services.

Therefore, in my opinion, an essential ingredient in any present or future monetary system must be an aggregation of national currencies which can be conveniently and freely moved from one market to another with no prohibition on investment or repatriation.

If the confidence, convertibility and access to capital market objectives can be achieved we can safely assume that trade, investment and capital flows will flourish as businessmen and individuals take advantage of the opportunities offered by the market place.

As we have seen in recent years, however, these objectives can be attained only if the monetary system provides adequately for the adjustment of the inevitable imbalances of trade and payments between countries. This is possible only when exchange rates among the different currencies are kept at realistic levels relative to each other. So there will be changes, and perhaps more quickly than has been the custom in the past. But in one form or another, there must be a system.

In practice there are other requirements. Convertibility is not likely to be maintained in a system that is prone to periodic crises and which impose unacceptable costs and strains upon the principal trading nations. Under such circumstances the first resort is controls. We may forbid controls as much as we like but, if governments find controls preferable to the costs and disciplines imposed by the market place, controls will be imposed. For example, consider President Nixon's recent request for controls on U.S. agricultural exports. Consequently, I believe that it is essential to formulate rules and mutually acceptable standards of behavior for the conduct of our international economic affairs. Such rules will inevitably impose constraints and disciplines upon individual governments. The objectives as outlined are exacting requirements and because they conflict with one another, all obviously cannot be fulfilled. Some require the maximum stability obtainable in exchange rates while others, at least under foreseeable circumstances require flexibility. Nonetheless, our ideals should be our guide because they force us to recognize that frequently we must give up something in order to achieve something else.

IV. THE PRESENT INTERNATIONAL ARRANGEMENTS: THE NONSYSTEM

At present the exchange rates are floating, and yet we do not have a system of truly floating exchange rates—responsive to market forces. Essentially, the central banks, though uncommitted to supporting currencies in the markets, are supporting or suppressing their currencies in other ways—through controls and restrictions on convertibility. It is my belief, moreover, that instead of fewer controls, the proliferation of controls will worsen.

A. The Argument In Favor Of Floating Exchange Rates Is National Autonomy In The Conduct Of Domestic Objectives

Admittedly, if we and everyone else followed a floating rate policy rigidly and consistently without interfering with its opeation we would rain greater freedom to pursue domestic objectives. We could adopt fiscal or monetary policies that meet our own domestic needs regardless of the condition of the dollar in international markets. If the dollar were weak internationally, the appropriate supportive policy would be higher interest rates, budgetary reductions and lower consumption. But if the economy were sluggish, the United States, under a floating rate system, could pursue expansionary fiscal and monetary policies, despite the international weakness of the dollar, and the impact would be absorbed by a downward adjustment in the exchange rate. In principle, we could ignore developments beyond our own borders, leaving these problems to be worked out by continuous and automatic small adjustments in the "floating" exchange rate.

But so far, the purported floating rate system has been an illusion. The Eruopean currencies are not "floating" relative to each other. The Asian currencies give every appearance of being "managed" relative to each other. The Western Hemisphere currencies, including the Canadian dollar, appear to be tied to the United States dollar. Thus, the present system is not a "floating" system in the true sense—it is simply a nonsystem. At best, it is a de facto alignment of regional currency blocs with the probability that one or all of these blocs will become more inward looking and protective. Instead of gaining "autonomy" in the conduct of our affairs, the extension and widening of the present nonsystem will, as a practical matter, mean additional foreign exchange controls as countries, unwilling to accept the domestic costs of exchange rate changes, strive to insulate themselves from these unwelcome influences. It will mean a "capriciously dirty" float and more and tighter controls as one nation and then another seeks to gain advantage or minister to some domestic need through interference with its international transactions.

It is sometimes stated that the present arrangement is working because under the old system the recent disturbances would have placed great strain on the various central banks. It is true that currently the central banks have been relieved of responsibility for intervention. But this is far different from saying the system is working. The central banks are intervening, but in a different way, through controls, and we have no rules governing central bank intervention in the markets or the types of exchange controls that can be used under specific circumstances. Nonetheless such interferences are not only taking place but they have already become a dominant consideration in the markets and, if we continue to drift along our present course, the impact will intensify.

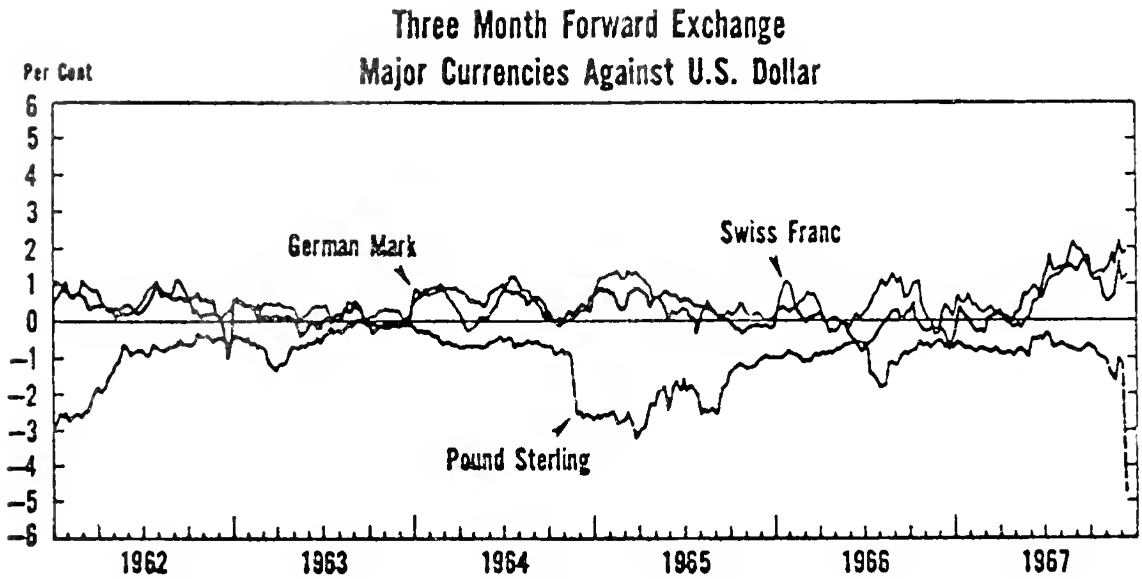
B. The Price of National Autonomy

The pursuit of "national autonomy" is a trade off involving more than one price.

1. More Disorderly Futures Market For Foreign Exchange

The long term futures market for foreign exchange transactions has weakened greatly. It has become very difficult even to obtain quotations for hedging longer transactions and the spreads are much wider so that an increasing proportion of long term contractual business arrangements are being hedged inadequately—only for short periods of time.

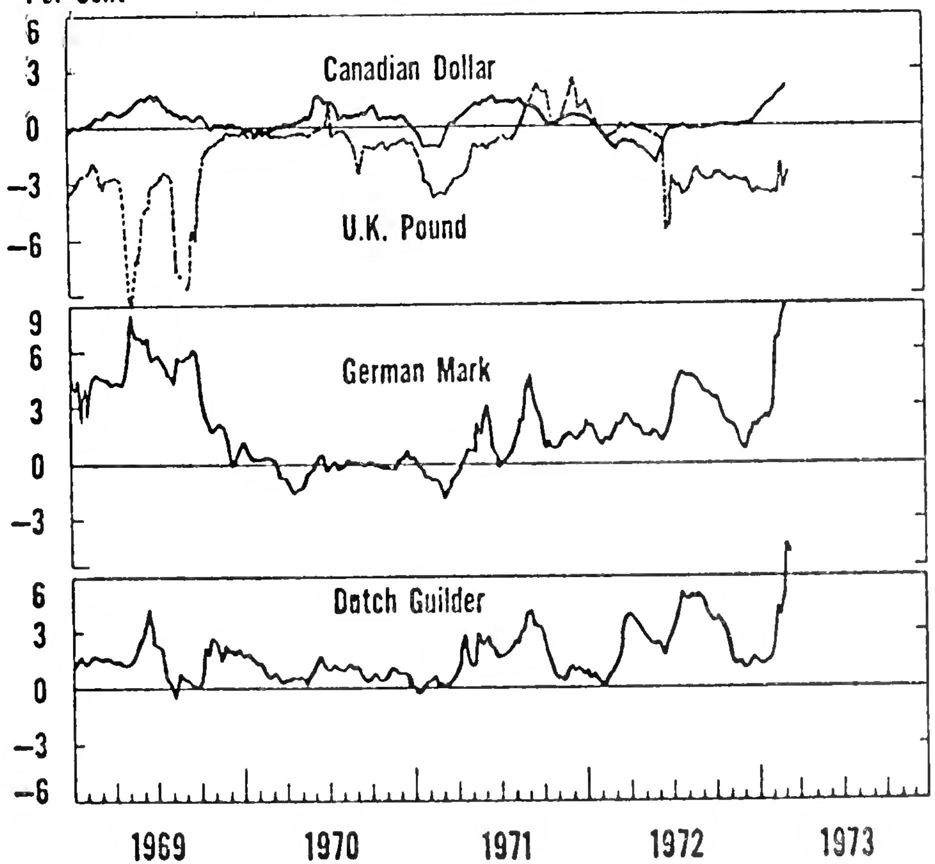
As the following charts indicate the costs of hedging (or insuring against changes in value) the various foreign currencies have risen substantially. The costs of hedging the Swiss franc, the DM and the Pound Sterling between 1962 and 1967 were generally less than 3 per cent and usually much less.



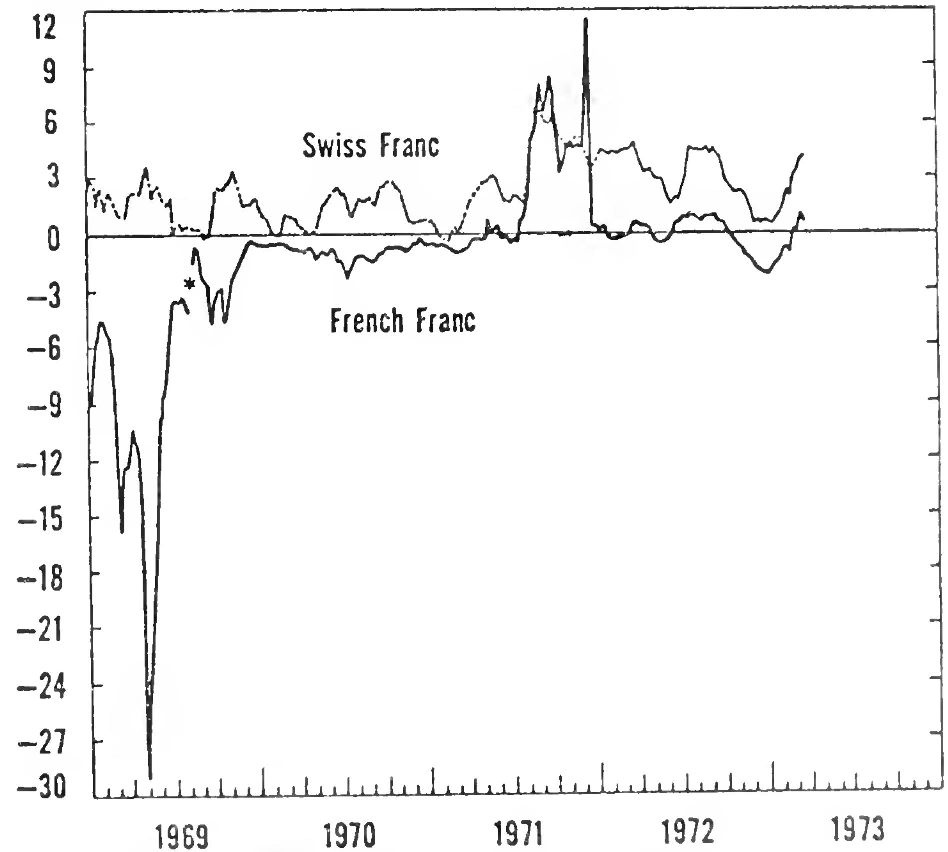
The period of large and generally stable hedge costs ended in late 1967. This coincided with the devaluation of the Pound Sterling and the increasingly obvious weakening of the dollar produced by the escalation of the Vietnam war, the onset of inflation and the declining trade surplus.

The period since has been one of virtually uninterrupted currency uncertainty. As the following chart indicates, the cost of hedging for three months fluctuated widely, after rising as high as 9 per cent, and generally much higher than prior to 1968.

Three Month Forward Exchange Major Currencies Against U.S. Dollar



Three Month Forward Exchange Major Currencies Against U.S. Dollar



* Devaluation of the French Franc from 4.94 to 5.55 for $1.00.

Without intervention points, spot prices are free to move and the futures widen considerably to protect against this risk with an unpredictable impact on interest rates. The wider the future discount or premium, the greater the differential interest rate between any two currencies concerned. And currencies will carry either positive or negative interest rates reflecting availability, structural weakness, and the degree and effectiveness of foreign exhcange controls.

At times of crisis, when the market thinks the spot rate might move shaprly, the short-dated swap costs become prohibitively expensive and interest rates, reflecting the swap cost on short term borrowings, rise sharply. Moreover, as the crisis intensifies, holders of assets denominated in the stronger currency obviously do not want to sell out of the strong currency into a weaker one, and conversely, those unfortunate enough to be long in the weaker currency are willing to pay substantial premiums to hedge their position. To do so, they may pay rates of 30 per cent or 40 per cent. In addition, any futures market that does exist tends to be one sided. For example, if the DM is likely to revalue, everyone will want to sell futures dollars against future DM. If the banks accept these contracts, they generally cannot "lay off" the other side of the contract, at least without paying very expensive premiums. So, the tendency is to take the wrong side of future contracts for good customers at some negotiated price (below what would have to be paid to "lay-off" the other side but substantially above the normal charge) and then cover the short future DM position by buying DM spot. This is why the volume of spot balances rises dramatically during a currency crisis and the movement of these spot balances from place to place, seeking some return or at least minimizing the negative interest rates which might be charged on these balances, creates the large capital flows experienced in the last few disturbances. Such instability, if continued, will progressively make the market undesirable for both borrowers and lenders.

For example, the following chart shows the interest rates on March 8 for Eurodollars and Euro DM and the cost of swaps and outright hedges. Notice that the net of the interest rates on the two currencies for the same maturity is about equal to the forward swap cost, which is what one would expect.

EURO INTEREST RATES, MAR. 8, 1973

[In percent]

	30 days	90 days	180 days
U.S. dollar	8.2	8.1	8.2
Deutsche mark	−5.0	−.4	1.7
Swap	13.2	8.5	6.5
Future hedge—outright purchase at point of time—dollar/deutsche mark	14.5	9.0	7.0

In other words, one could borrow dollars in the Eurocurrency market at 8.2 percent. At the same time, because of the likelihood of an increase in the exchange value of the DM, there was a negative return of 5 percent on the purchase of DM's with a resulting net interest cost differential of more than 13 percent. In similar fashion, if one wished to hedge the value of a dollar asset for 30 days—the weaker currency at that point in time, March 8, 1973—one could sell dollars for DM's for delivery 30 days hence at a cost of 14.5 percent.

On the other hand, when the crisis passes and the markets settle back to a more normal condition, these short-dated swaps decline sharply. For example, this table shows the rates and cost of hedging on June 18, 1973 when the swap cost on 90 day transactions was only 2.3 percent.

EURO INTEREST RATES, JUNE 19, 1973

[In percent]

	30 days	90 days	180 days
U.S. dollar	9.2	9.3	9.5
Deutsche mark	8.1	7.0	6.7
Swap	1.1	2.3	2.6
Future hedge—outright purchase at point of time—dollar/deutsche mark	1.1	2.3	2.6

Notice again that the net of the interest rates on the two currencies for that maturity almost equals the forward swap cost. The cost of hedging 30 day maturities was slightly more than one per cent.

2. Reduced Liquidity And Fragmentation Of The Markets

Every time a new control is added, or another money market is isolated by restrictions, liquidity is reduced. There are lots of dollars but they are not synonymous with liquidity if banks, businesses, and individuals are prevented from using them.

As an example, we might take the isolation of the Deutsche Mark market. The American bank manager formerly could make a DM loan to a German borrower which could be funded either by acquiring DM deposits in Germany or by borrowing Eurodollars and converting these Eurodollars to DM on a hedged basis. But the bank manager cannot use the Euromarket-created DM's in Germany. He cannot place them on deposit in a German bank because the German bank (subject to 100 per cent reserve requirements on such deposits) charges a daily service charge to keep the money. He cannot buy DM securities because a non-resident cannot purchase domestic securities in the German market. He cannot lend them to a German commercial borrower because such borrowers must maintain 100 per cent reserve requirements with the Bundesbank on funds acquired outside Germany.

Reserve requirements on foreign funds brought in, June 15, 1973

Country:	Percent reserve
Germany	100
France	100
Australia	25

So the DM market has been broken out and isolated from the worldwide money market. The same can be said in varying degrees for French francs, Australian dollars, and other currencies. Thus, the free world money market has been divided into isolated units where dealings in each market must be indigenous to that market—and this disintegration has reduced liquidity.

And worse yet, if the common European float gains strength, the controls which effectively screen out Eurodollar loans from the various national markets probably will be relaxed or eliminated with regard to the various European currencies engaged in the joint float. This would mean guilders could be economically created with DM borrowings, or French francs with guilder borrowings, but it would be far more difficult to do the same thing with dollar borrowings.

3. Additional Foreign Exchange Controls And A Severing Of The Ties Between The Domestic And International Currencies

The pursuit of national autonomy in the formulation of domestic fiscal and monetary policies through floating currency exchange rates will produce pressures and strains leading to nonconvertibility, exchange controls and a severing of international ties.

If an easy money policy and low interest rates are dictated by domestic conditions and the country does not wish to see capital outflows and a lower exchange rate, some form of control, such as our interest equalization tax, will be adopted to keep lower-rate funds in the domestic market from seeking the higher rates of the international market. Conversely, a nation already experiencing inflationary pressures and simultaneously receiving large capital inflows will erect exchange control barriers to retard or curtail these inflows. Thus, in my opinion, floating exchange rates coupled with national autonomy means a system where currencies cannot be freely interchanged. It will also mean a system where the same currency will carry one interest rate domestically and another interest rate internationally, thus creating two separate pools of funds with all the attendant controls necessary to keep them segregated.

It is fashionable to argue that these are minor inconveniences and that the flows of trade and foreign investment will not be seriously affected. This may be true but I do not believe it.

Trade and investment will eventually feel the impact of this proliferation of controls and reduced currency convertibility.

4. Greater Fluctuations In The Domestic Prices Of Internationally Traded Goods

Changes in exchange rates are necessary in order to adjust imbalances in trade and overall international payments. Nonetheless, the exchange rate of a country's

currency relative to others is probably the single most important price in existence for that economy, because it affects the domestic price relationships for a wide range of goods.

One of the unpleasant side effects of devaluation is that it raises the cost of imports—in the same manner as a tariff. In addition, it also provides a protective umbrella for price rises on competitive products of domestic origin. Moreover, by enhancing the competitiveness of domestic goods in international markets, exports increase, further aggravating the scarcity of goods in the domestic market place. The resulting changes in consumer and wholesale prices are undesirable developments, both to the community at large and politically as well.

The devaluation of the dollar added to the sharp upward movement in our farm product and food prices. The intended result of the devaluation was to cheapen exports so that we would sell more abroad and to make imports more costly to U.S. citizens, i.e., dampen consumption by increasing prices. This was the announced objective and it has worked. Prices did in fact rise.

Yet, as announced last week, we are unwilling to allow the policies to work toward the desired end, and instead are going to license farm product exports so as to conserve our supply for domestic use.

The pressure caused by higher food prices in the U.S. caused a basic change in U.S. policy regarding agricultural exports—and one with grave repercussions for the upcoming trade negotiations, in which one of our basic objectives is to obtain better access to the EEC and Japan for farm product exports. This is essential to the longer-term prospects of restoring our trade surplus. Yet now we tell important customers like Japan, which is dependent upon us for food supplies, that whenever pressures in the U.S. mount, we will restrict their access to our exports. The abrupt switch in our policy has also weakened our chances of negotiating better access for our farm product exports to Western Europe in forthcoming trade negotiations.

C. In Reality, National Autonomy Is Permissiveness To Pursue Political Objectives Of Momentary Advantage Which May Prove Inconsistent With The Longer Term Mutuality Of Interest Which Any Meaningful Trade Agreement Requires

It seems to me that successful negotiations reducing tariff and other barriers to U.S. exports will be impossible without some mutually acceptable agreement on exchange rates. How can meaningful trade concessions be negotiated within an atmosphere of volatile exchange rates? A rough idea of what exchange rates are going to look like in the future is required simply to assess the impact of trade concessions on domestic production and employment. Without stability in exchange rates, tariff increases or reductions are illusory. What good does it do to reduce tariffs on widgets by 15.2 per cent in return for a 25 per cent reduction in foreign tariffs on agricultural products if currency changes alter the trade boosting impact of the concessions on the next day? The only meaningful protection in such an environment becomes quotas, and quotas are the worst of all possible barriers to trade. Consequently, it is my belief that the slightly greater degree of national autonomy that we may achieve through floating rates will inevitably be accompanied by very heavy longer-term costs. Some of these are already becoming evident and unless our present course is altered, controls on currencies will continue to proliferate. Convertibility, confidence and convenience will continue to wane and political and economic frictions produced by the efforts of country after country to insulate themselves from the domestic side-effects of floating rates will further worsen international relationships and eventually choke the flows of trade and investment.

At the heart of the problem is the desire to avoid international burdens or responsibilities even when a mutuality of burdens and responsibilities is clearly an essential quid pro quo for the achievement of other vital goals.

Confidence in the dollar, whether at home or abroad, requires that we demonstrate a willingness to subject ourselves to the disciplines required to reach the goals that we seek—instead of searching for ways to avoid them.

I do not believe that our fiscal performance has inspired confidence abroad in our determination to maintain a stable price level. We have had a budget deficit in all but one of the past fourteen years. Similarly, with the exception of a brief period in 1966 and again in 1969, monetary policy has been consistently expansive, and by a substantial margin in recent years. Moreover, we have shown an increasing willingness to interfere with the operation of our own markets and our own economy in ways that are inconsistent with the avoidance of inflation. We appear less and less willing to allow prices and interest rates to respond to basic supply and demand forces—at least if this is painful or unpopular.

Our unwillingness to subject ourselves to the disciplines required to avoip inflation makes suspect our desire to get away from gold and our reluctance to defend exchange rates against speculative assault even when we believe the rates are realistic. In the international sphere we do not believe in international monetary responsibilities that take priority over national autonomy in the formulation of domestic needs and yet we seek worldwide cooperation in the ordering of a new monetary system. In this matter, as in most others, I do not believe we are going to get something for nothing. Instead, a smooth and properly functioning monetary system that aids the vital flows of trade, capital and technology is going to require the assumption of certain burdens and responsibilities both by ourselves and by our trading partners. The obligation to do our part in these burdens and responsibilities will by definition mean some surrender of "national autonomy." What we get will, in short, depend upon what we are willing to give up.

V. A PROPOSAL

A. Be Willing To Negotiate On All Facets Of A New Monetary Agreement

I have indicated my own biases and ordering of priorities earlier. They include currency convertibility, freedom from controls, and markets that respond, insofar as possible, to the operation of market forces. In achieving these ends, however, it is obvious that we must have a monetary system that does not impose intolerable and unacceptable strains on its members or it will break down. To this end a mutually agreeable code of conduct or behavior is essential and it seems to me that we might usefully offer to negotiate:

1. Parities

Re-establish parity relationships between the dollar and other currencies. This might be accomplished by a widening in the allowable range of fluctuation beyond the plus or minus 2¼ per cent in the Smithsonian Agreement.

2. Responsibilities

Negotiate an arrangement establishing explicit procedures for determining the responsibilities of the parties to the agreement.

3. Penalties

Establish penalities that parties to the agreement can impose upon other members who fail to live up to the agreement. This might be an extension and expansion of the approach originally envisioned in the scarce currency clause of the original IMF agreement, which did provide for the imposition of sanctions under specific circumstances.

4. Currency Support

Require countries to maintain the parity value of their currencies (holding the market value within the allowable band of fluctuation) at any and all costs—until change is called for under the agreement and then to make that change under the prescribed procedures. The arrangement would require both a definition and a mechanism for deciding when a parity change would be required and implemented, together with the penalities that will insure that a timely change is made both by countries that must revalue as well as countries that must devalue.

B. Be Willing To Surrender Some National Autonomy In This Joint Undertaking

Implicit in the whole approach of course, is the willingness of the leading countries of the world to enter such a cooperative arrangement, and thereby sacrifice some amount of their jealously guarded national autonomy. This is obviously a difficult and perhaps impossible utopian task. But more may be possible today than we realize—simply because the present situation is already imposing intolerable strains on the main trading countries. In addition, I believe that much of the present impasse is the result of both ourselves and the other countries approaching the negotiations with preconditions that were unacceptable to the other parties from the outset.

To begin with, as the Bretton Woods system began to break down, both the United States and our trading partners reexamined their positions and formulated their grievances largely upon the basis of their own individual self-interests. Obviously, self-interest is important—it is what makes markets operate so well. But bargaining positions developed and solidified that were often based upon narrowly defined domestic economic and political considerations. Moreover, ideologies developed and crystalized in the procedure that now seem to have as much force as the original positions themselves. And somehow, in the ensuing debate we lost sight of both the larger goals and objectives and failed to consider whether our

individual bargaining positions could be reconciled with the attainment of the overall objectives. When the system finally collapsed, the ideologies were left in confrontation with each other. It was then a matter of fixed vs. flexible rates, of gold vs. paper currencies, of monetary negotiations first vs. an insistence that they go hand in hand with trade negotiations or conversely, as presently appears to be the case, trade negotiations first and monetary negotiations later. How these proposals would work in practice and whether they were consistent with the needs for an enduring monetary arrangement became a secondary consideration, and the requirements of actually negotiating the agreement received even less detailed attention.

The methods and the procedures, which should have been negotiable, became the objective. We seek national autonomy, but, in fact, we are not autonomous. We must accept combined or joint responsibility in devising and operating a mutually agreeable system. The fulcrum of a workable agreement has to be a balance of national autonomy and the assumption of mutual burdens. It is my belief that in achieving this balance, national autonomy and the desire to excape mutual responsibility are much less important than the restoration of convertibility, transferability, and the removal of controls.

C. Support The Dollar Internationally

The resumption of a policy of support for the dollar in the foreign exchange markets would produce a number of benefits.

1. Confidence And Orderly Markets Would Be Restored

Much of the lack of foreign confidence in the dollar stems from our unwillingness to defend the dollar internationally even though we agree that it is basically undervalued on any basis of comparison. Others wonder why the marketplace should be expected to support the dollar until the U.S. government itself takes the first step, arguing that our unwillingness to do so also signifies unwillingness to adopt and follow the basic policies and disciplines required to maintain a strong dollar over the longer pull. And psychologically, there's something to be said for this argument.

It is my belief that support of the dollar, if accompanied by evidence of appropriate domestic policies, would improve foreign confidence in the dollar and restore some measure of order to the foreign exchange markets.

But apart from the very considerable restoration of confidence abroad, there are real economic benefits to be gained by resuming support of the dollar at this time.

2. Inflation Would Be Dampened

The U.S. economy is now running virtually at full capacity. Insofar as the current dollar exchange rate is artifically low (i.e. the dollar is undervalued) the resumption of support operations by the United States would produce a significant rise in the exchange rate. This might deter the expansion of our exports. However, just as the declining dollar exchange rate has spurred price increases, a rising exchange rate would take some of the edge off the current surge in inflationary pressures. In real terms fewer exports and more imports would mean enlarged supplies of goods for consumption in the U.S.

3. The Capital Markets Would Strengthen

A strong dollar appreciating in value would impart confidence to the capital markets. The stock market would shed its lethargy and rise—helped along by the inflow of foreign investment capital and perhaps also by the removal of the CID restraint on dividends. Long term money presently sitting on the sidelines waiting for higher yields on fixed income securities would conclude that rates have topped out and would enter the market place. And this, too, would strengthen the capital markets.

4. Improved Relationships With Other Countries Would Brighten The Chances For Meaningful Trade And Monetary Negotiations

The tensions and differences produced by the exchange rate impasse do not leave much realistic hope for meaningful results in the forthcoming trade negotiations. The failure of these negotiations would be a huge disappointment in themselves. But, against the present background of tension, and proliferating controls, failure in the trade talks may well mean the final end to the post World War II era of trade expansion.

Resumption of support for the dollar would indicate a willingness by the United States to assume some measure of responsibility in a new monetary system. It might, therefore, be instrumental in breaking the present deadlock.

The argument against moving to support the dollar is that such an effort might be costly to the taxpayers and merely delay an exchange rate adjustment which will ultimately occur anyway.

In some cases, this has certainly been true, although the impact on the taxi payer is not always simple. Assuming the support operations are conducted by borrowing foreign currencies and purchasing one's own currency with the proceeds of these borrowings, there will be a loss on the foreign currencies borrowed if the dollar declines on a permanent basis.

Even in this case, however, there will almost certainly be a profit on the reserve assets (such as gold) remaining after devaluation. Moreover, for a country like the United States, where foreigners hold substantial claims (i.e. the oversea dollars in the hands of foreigners), these claims can be redeemed by fewer units of reserve assets or foreign currencies if the dollar declines further. Without belaboring the point, measuring these costs to the taxpayer is complex.

In my opinion, the impact on the domestic economy is the appropriate criterion for assessing an exchange rate change—i.e. whether it is inflationary or deflationary, whether it corrects imbalances in trade and payments and, whether it compliments and is consistent with the overall range of monetary and fiscal actions deemed appropriate for the domestic economy at the time. In other words, if the expected impact of a devaluation on the domestic economy was inconsistent with other economic action then being pursued, it might be appropriate to support the national currency at any cost in order to keep the general economy on an even keel. Conversely, the same might be said for a revaluation under some circumstances.

Support for the dollar in international markets at the present time is totally consistent with the broad range of economic actions that we should pursue at home. We are suffering from inflationary pressures and a de facto increase in the dollar exchange rate would be deflationary. Almost all observers agree that the dollar is now undervalued so that we would not be in a position of artificially propping up the dollar and simply postponing an ineviatble further decline to the future.

We expect near term improvement in our trade and in our overall balance of payments. Thus, the support operation at this particular time would be nothing more than a bridge until the expected longer term improvement materializes. In other words, support operations today would be consistent with the underlying economic trends (not contrary to them). Consequently there is an extremely strong possibility that dollars purchased at their presently depressed level will subsequently be resold at a higher and more favorable exchange rate. If so, there will probably be a profit on the operation even after allowance for the differential interest cost between the interest paid on the foreign currencies and the interest earned on the dollars purchased.

D. Combat Inflation At Home

There is no area in which progress is so essential as in the control of inflation. Distrust of currencies and money in general is the direct result of sustained inflation. No conceivable monetary system can be a substitute for discipline. Nonetheless the Bank for International Settlements, in its annual report, points out what is evident to all of us: "The fact is that the authorities in almost all countries have in practice reconciled themselves to lower standards of performance in containing inflation." Many investors do not consider the U.S. dollar a safe haven any longer and controls restrict access to the stronger currencies. The worsening in inflation, moreover, is not confined to the U.S. As Jelle Zijlstra, Chairman of the BIS and head of the Dutch central bank noted, prices "are rising two or three times as fast as a few years ago and there is not any particular reason why the process should not continue." Without a greater measure of price stability by the U.S. it will prove impossible to restore confidence in the dollar.

1. Adopt and Follow Appropriate Anti-Inflationary Fiscal And Monetary Policies On A Consistent Year In And Year Out Basis

The United States, for too long, has allowed fiscal and monetary policies to be determined by the short range needs of the moment. We have vacillated widely between brief periods of policy restraint and longer periods of policies designed to stimulate the economy—with a resulting longer term bias toward over-stimulus and inflation. Economic policy, instead of trying to smooth out the short term ripples in business conditions, must concentrate more consistently upon the objective of stable prices and a stable value dollar.

Controls are not the answer to inflation. A control program, at best, can do no more than postpone inflation—disguising its effects until another day. The present freeze will be no different. It will purchase time, a brief period during which remedial policies can be adopted. Instead we must concentrate on the main causes of inflation and these are too much monetary and fiscal stimulus. Instead of allowing fiscal and monetary policy to gyrate from over-stimulus to over-restriction we need more steady growth oriented policies with less of an inflationary bias.

2. Policies To Boost Productivity And Maintain The Competitive Position Of U.S. Industry

a. Restrain Total Demand And Divert A Larger Proportion Of Production Into Investment

In addition, however, the longer term need to boost productivity, develop and adopt new technology and maintain our competitive position will require substantial investment to renovate and upgrade our productive facilities. In order to do this, we will require a higher rate of savings. If we can reinvest a larger proportion of our output in modern, updated and more productive facilities, we will better be able to compete abroad and meet our domestic needs as well. This will require discipline.

b. Remove Bottlenecks and Inefficiencies In Production

This is much more than the question of asking the assembly line worker to be more attentive. It's the whole system of values which you and I and every citizen of the United States deem important, because these values get translated into our costs of production. For example, do we want cheap energy or clean energy? Do we want efficient lower cost production or pollution control? Do we want lower cost production or product safety?

I agree with the higher standards and the desire to improve the quality of life. But we are going to pay a price to achieve these goals—the diversion of more of our production away from consumption and into low-return investment.

Do we want lower cost production or military leadership? Do we want to restrict nuclear proliferation and the maintenance of our troops abroad? If so, it will continue to be an expense which through our taxes goes into production costs. These are hard, difficult and important choices and we should make them honestly.

c. Spur Research In High Technology Areas

Our research effort probably should be redirected away from a military and space related concentration toward areas that would enhance our productivity and solve specific but serious problems. We face both an energy crisis and a longer term problem of rising energy costs, and we are in an excellent position to turn the problem to our longer term advantage by being the country that develops the technology to solve or alleviate this problem.

VI. CONCLUSION

Admittedly, we have our problems—and they are serious. But they are not new. At the same time, we have both the ability and the opportunity to begin to fashion effective remedies.

A. Support The Dollar And Move Toward Comprehensive Negotiations On A New Monetary System

As I have argued earlier, I believe that a policy of support for the dollar would be an important first step in restoring confidence in the dollar. In addition, I believe that this would ease the tension between ourselves and the other leading countries and open the door for meaningful negotiations both on trade and the creation of a new monetary system.

We also have the opportunity to avoid the illusion of national autonomy and the costs that will result from a continued drift into a floating rate system. National autonomy simply does not exist in a world of economic interdependence—especially for a country as large and as important as the United States. We have the ability to lead and unless we do so intelligently, we face a future of controls, currency inconvertibility and dwindling trade and investment. We need the discipline of a parity system of exchange rates both as a focus in the fight against inflation and to maintain harmony in international relations.

B. Reexamine Our Domestic Priorities And Adopt The Policies And Disciplines Required To Attain Them

We must admit that not all things are simultaneously possible, and adopt priorities. There is room for much debate in any such ordering but I believe that we would all agree that a better control of inflation is required to attain almost any of our objectives. Until we agree on the need for stable prices, however, and commit ourselves to the task, we are not likely to fashion an effective and enduring remedy.

Perhaps the time has come for a legislative enactment requiring the Federal Reserve and the Executive branch to maintain stable prices and the purchasing power of the currency. We have the Employment Act of 1946, but we do not have similar legislation expressing national determination to maintain stable prices. Perhaps it would be appropriate for the Congress to enact such legislation.

Chairman REUSS. Thank you, Mr. Abboud.

Mr. Hawes, please proceed.

STATEMENT OF JOHN HAWES, JR., FIRST VICE PRESIDENT, BANKERS TRUST CO., NEW YORK, N.Y.

Mr. HAWES. Again I appreciate very much being asked to join this discussion.

I have been in the banking field since 1932. And in 1936 I became a foreign exchange trader. And I have traded foreign exchange actively from that time, save the war years, until 1970. I am still very close to the daily operation of foreign exchange, being responsible for the function within my bank.

Chairman REUSS. Anybody who entered the banking field in 1932 was a hero.

Mr. HAWES. I find that my colleagues found that only 12 of my class were so moved, and it was a doubtful thing, but we stayed with it.

In my rather short prepared statement to the committee I believe I made clear my disbelief in the value of floating exchange rates. And I would read one or two parts of that prepared statement and make a few remarks in connection with that.

Chairman REUSS. Please read as much as you care to.

Mr. HAWES. I will skip the first part, which is just the background to the present situation. As I understand it, the committee is particularly interested really in how well a fluctuating exchange rate is working. My view is rather narrow, but I would like to believe that because of a long period of time involved in this matter I have learned something.

The floating rates are not a new phenomenom, as I have said, to the exchange market.

Surely in trying to judge the value of the floating rate today, and its effect on the market, one has to realize that in a very short space of time, 14 months, as is often noted, but since the Smithsonian Agreement it is a year and a half, there have been very sharp changes in fact in the exchange parities. And these changes themselves are probably yet to work their way through the economic and financial community to give a clear understanding as to what that rate change itself means. And so involved in the same consideration, I believe, is this question of what effect is the floating rate itself having.

However, one can't help, I can't help as one involved in the marketplace but make some judgments of the floating rate itself. But I do stress the fact that the parity changes—and we hear this constantly

from our commercial people, about which I would like to speak a little later—are perhaps at one moment more the problem than the floating rate. Customers are catching up with the floating rate atmosphere, many of them, not having been aware of any such possibility previously.

The results across the world of the devaluation of a currency—and we have now had two devaluations in this 14-month period—I believe economically take as much as a year and a half to 2 years to become clear. And so we would like to believe from results that we are hearing in these last few months in our trade position, that the fact of devaluation is showing a beneficial effect to the country in its foreign trade.

I read this morning a few comments that have been made to the committee by the commercial community. And I believe in my prepared statement to the committee the principal thing—and I only have a few points to perhaps speak to from the marketplace—but the principal thing that we see is indeed the cost involved to the community. And that is the commercial community, the financial community—to anyone who is interested and has a concern with the foreign exchange market. And there were certain different views I believe expressed. Of course, I only read a news story of yesterday's hearing. But that fact seems to come clear, the cost of the marketplace. And this is something that I feel very strongly. We have not made a survey. On the other hand, as with all of those involved in the financial side, we speak to a great many commercial companies, large, medium, and small companies. And we have made perhaps our own judgments. And I would hasten to say that mine perhaps are based on my views from the past, but I feel quite strongly that this floating rate situation which is here to stay for some while—and I only would like to say now that I hope we don't become too enamoured with it—is at a cost. And that is a cost that I would like to speak to briefly.

And without getting too much into the detail of an exchange market, the future exchange which is a vital part of a commercial problem, and has become once more realistic to them, or perhaps to some, they are only just now aware of the need to cover their future exchange commitments. This cost of exchange is expressed, and has been up until this time of floating rates, very clearly as a percentage. And the cost of hedging a future contract in foreign exchange can be estimated, was estimated, I might better say, when we had a fixed parity system as the difference between the rate existant at that moment, the base rate or spot, as we call it in the exchange market, and the forward market. And you took the forward price for 6 months and you related it to a 1-year base, you doubled it for 1 year, and you converted that against the spot exchange rate, and you then had a percent-per-annum cost at which you could hedge your forward exchange.

This is a little mathematical operation that is rather easy to do by any large commercial company, or any small one. What that cost represented is important in calculating the values of a business deal. And it must be figured in this commercial contract.

Today we have no point from which we can be sure we can figure this. That base point, as we knew it in the past when we had fixed rates, was within a small range of 1 percent either side of the agreed parity under the IMF rules. Today there is no fixed point. And that figure from which a cost of doing future exchange business may be estimated—and it is a big point of estimating—is now varying by 1,

2, and 3 percent. In the spring it has been as much as 5 to 8 percent from what it was only a few weeks before. This is a difficult thing, just to calculate in your commercial and financial operation, but finally, after you have been through this a few times, a difficult matter to absorb. And it must in every sense, I feel, affect the cost of operations. And as I have noted in my prepared statement, at certain points, pending the type of business, it comes down to a cost that is going to be reflected to the ultimate consumer.

This cost—I hope I don't create confusion here—is also increased by the fact that under floating rates the market place is not as broad a market as it was under a more fixed rate in which more people were willing to undertake the risks involved in the marketplace. Today, with the uncertainties—and they are big, and they grow bigger at times, and they become less—but there are bigger uncertainties in the marketplace, and consequently, in any business terms, there are some who do not wish to accept the risks. And they become lesser participants in the future exchange market which is, I feel, a vital area of commercial interest. And as there are fewer who are interested, then those who remain must necessarily, in order to find means of protection over the time or to assume the risks inherent in the business, must do business only at wider spreads in the market. And this is not in order to gain a greater return by any means, but it is to cover the possible risks inherent in this business. And this cost has got to be translated into the commercial terms.

That this has increased in these last few months is quite certain. It may at other points in time be slightly reduced, because there is a calmer climate and certain matters that at this moment particularly are affecting the exchange market, the political matter that we are all aware here has affected exchange widely—these will slow down, and the market will be better at that time. But whether it will bring a return to a real stability and more participants to the market, which is the thing I think, I believe is doubtful.

If there is a further question—although I don't know that this detail is that important—as to how one calculates future exchange, I would be glad to speak to it.

The longer that the system, as the question was addressed to us, is in place, I feel the more likelihood there is of a general proliferation of other types of controls, not necessarily of an exchange nature, though there will be those, but of a commercial and financial nature as well. I believe this is something that Mr. Abboud indicated too.

The market in such a situation is bound to suffer. The market today—and we knew this a little before the coming of the floating mechanism—we have specifically, as an example, negative interest rates applied by countries, certain countries, and I believe a year ago it would not have been felt that this would happen in the particular areas. As a measure of controlling their own exchange problem, Switzerland imposes a negative interest factor on balances maintained in accounts there. This is true to a degree in other countries. And to the exchange market, which is, I believe, the problem we are addressing, this becomes a real difficulty. Exchange is a commodity business, and you have to have a balance in a foreign country in order to handle your daily business. If you were limited in any manner as to how you can operate that balance yourself, you are more limited in your ability

to take care of the customers' problems that you are in business to handle.

Similarly, the customer must feel the effects of this. And we have seen this take place in these last few months very clearly. At times a customer will need a particular amount of money, and as part of our business we are prepared to offer this. But if we don't have the availability, and we know because of market conditions at that moment, that particular day, it is particularly difficult to come by, then the price is going to reflect this.

So again I only wish to emphasize that as a result of the floating exchange, I feel that we will have more restrictive measures, and they are costly.

I have one other thought. In the whole of the marketplace even under more rigid or fixed system, there are swings. These swings in the fixed system were limited. But the pendulum in any matter swings back and forth. And today the swing has no limit, it can almost go the circle, if you will, affected not only by matters that are of a commercial, economic, or financial background, but by other types that really should not have the effect on the marketplace that they do have. And as such they can lead, as we have known even under a fixed system, to perhaps disastrous results if allowed to go too far.

This is where I feel too that to the second particular question asked by the committee on intervention and quidelines that might be suggested for intervention in the market, intervention plays a very important part in international exchange matters. And as I believe I have stated in my prepared statement here, it is a matter that requires great judgmental decisions. It is a matter as to which I feel it would be presumptuous on my part to state guidelines. But I would feel that the importance of it must be emphasized. It is an important part. And I have nothing further to enlarge on my statement there. I think that perhaps indeed, just as we have an open market committee under the Federal Reserve, a committee on international monetary policy that could work with proper directives too through the marketplace and the authorities who have the responsibility of carrying out the policy would be very helpful to the market.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Hawes follows:]

Prepared Statement of John Hawes, Jr.

Floating rates of exchange are not a new phenomenon to the exchange market. Following the monetary disturbances of the early nineteen thirties exchange rates fluctuated widely frequently in response to manipulation by national authorities. The war years brought down hard controls on all international monetary activity. From this background and with the belief that a stability in foreign exchange markets would help to promote the growth of international trade and investment, the Bretton Woods agreement came into being. With few exceptions, notably the Canadian dollar which floated for a decade, the principal currencies of the world were held to fixed parities of exchange for 25 years from the end of the war. World trade greatly expanded during this period and a substantial part of this expansion can be attributed to the stable monetary system. That system was finished in the summer of 1971, although a growing volatility within the exchange market had become evident several years before.

It is too early to make an overall judgment of the present fluctuating exchange rate mechanism, made up of floating rates and wider bands of exchange. Heavily involved in any judgments are the large parity changes of principal currencies versus the U.S. dollar over the 1971–73 period and the adjustment that these

changes bring about in trading and investment outlook. To say that international trade and investment have been either facilitated or impeded by introduction of fluctuating exchange rates may be overlooking the time frame needed to assess the outcome of two devaluations of the dollar within 14 months. It is generally felt that results internationally of a devaluation do not become clear in a country for as much as 18 months, possibly 24. Economists point to the recent improvement of the trade balance as resulting in large part from the dollar devaluation of December 1971.

It seems unlikely that international trade and investment will be facilitated by a long-term continuation of a fluctuating exchange rate mechanism. The uncertainties and risks inherent in the fluctuating-floating-markets will act as a deterrent in the decision to undertake international commitments. The cost of hedging future exchange commitments is difficult to determine with any precision. The forward market in foreign exchange is a reflection of interest rate differentials between any two currencies and is affected at times by fundamental trends in currencies. Under the fixed rate system of exchange the cost of hedging future commitments could be calculated with a degree of certainty because the spot rate was a stable point of reference which could only move within a 2% range (although this band was widened in the Smithsonian Agreement to 4½%). Under the fluctuating or floating mechanism which we are now experiencing the spot rate of exchange moves at will and in a given day has ranged as much as 2 to 3%, and over a few weeks some rates have moved 5 to 8%. It is therefore extremely difficult for everyone in the market to calculate and finally to absorb the wide ranging cost of hedging exchange.

As a strictly market matter the future market in foreign exchange is working reasonably well in the floating atmosphere of the day, with ample opportunity to make future hedges to one or two years. In fact there is business done in a few important currencies at 3 to 5 years. It should be emphasized that while the need to hedge future commitments in a fluctuating market is even greater than before, the increased cost of doing so must be absorbed in the commercial world and will be felt by the ultimate consumer.

As the fluctuating system is in place for a longer time some of the pressures on the market resulting from the end of the fixed parity system may recede. The willingness of more parties to enter the market and assume the risks inherent therein may grow and if so the market would be the better for that. However, the ever present possibility is that financial and political events will affect cost and risk factors and will tend to keep some participants from actively engaging in the present fluctuating markets. This leaves the market thinner and more expensive to those who do make use of it.

Further risks in a long period of floating are the implementation of a "controlled" float or other measures of a financial and commercial nature to improve a nation's international position. Any proliferation of controls of this sort will adversely affect world trade and the function of the exchange market that is a vital part of the structure. The floating exchange arrangements have not yet allowed a number of strictly monetary controls to be removed.

Foreign exchange markets are sensitive to more factors and more events than perhaps other commodity markets and security markets. World-wide commercial, financial and political matters all bear on foreign exchange decisions and the resulting market rates. Monetary turbulence is greater in the atmosphere of fluctuating or floating rates than in the system of fixed rates. It can be hoped that the present situation is one of transition and will not be of long duration. But overall if nations act solely in response to domestic economic priorities and without regard to international welfare, turbulence in the monetary field could exist under any type of monetary arrangement.

Central bank intervention in the exchange markets traditionally plays an important part of an international monetary arrangement. Guidelines to the intervention authority must be broad, even open ended. If rigid lines are set forth, they will be difficult to maintain under all conditions and might be taken as absolute guides (signals) to the market place. Surely the goal of intervention must be to temper a move that to the authorities is ill founded, and if allowed to proceed at too fast a pace could be destructive of the general good. On the other hand intervention should not be used to "buck" a trend. It may be used to aid a constructive trend.

There are great judgmental matters at work in the decision to intervene. Just as the Federal Open Market Committee makes periodic determinations that are translated into market activities, perhaps a Committee on International Monetary Affairs could propose guidelines under which the designated authority would

intervene in the exchange market. Officials who are knowledgeable about the foreign exchange markets can best propose and seek authority for the specific conditions under which they would function.

Chairman REUSS. Thank you, Mr. Hawes.

Mr. Leclerc, please proceed.

STATEMENT OF ROBERT F. C. LECLERC, VICE PRESIDENT, CONTINENTAL BANK INTERNATIONAL, CHICAGO, ILL.

Mr. LECLERC. Having spent most of my banking career as a foreign exchange trader, I also have certain biases of my own, particularly over the past several months when we have been subjected to rather consistent pressures in the international monetary field. I think probably the major bias right now is, we are getting somewhat tired.

The introduction of floating exchange rates seemed to be the only alternative available to the countries who were under tremendous pressure to accept massive amounts of capital moving across their national boundaries, under the previous system of more or less fixed exchange rates. This has not solved the fundamental problems underlying the international monetary system. Recent periods of currency turmoil appear to stem more from noneconomic factors than basic economic conditions or developments. The present climate in international financial markets is such that favorable news tends to be discounted while negative news is magnified. International trade and investments have continued to expand during the past 2 years of currency turmoil. It runs contrary to traditional thinking that stable exchange rates are essential to continued expansion of world trade and investments.

It should be noted, however, that generalized floating is barely 4 months old, and that the resultant wider spreads and higher forward cover costs will likely result in higher prices on goods and services in international commerce.

One example of these higher costs is the commonly seen spread at percentages as wide as the old Bretton Woods band of 1½ to 2 percent. There is as a result concern as to whether trade and investment can continue to expand in the face of continued and mounting currency uncertainty. The abandoning of the fixed-rate system has relieved central banks of the obligation to defend a currency's value in the face of massive capital inflows. These flows are often the result of changes in the Nation's domestic monetary policy which precipitate interest rate differentials as well as to create currency speculation. The attempt by a country to control large capital movements by changing exchange parity rates, or allowing a currency to float before there has been a major effect on the Nation's international reserve position, has not worked. In the past the response to massive capital flows was to defend the existing exchange rate parity at almost all costs, and only as a last resort to change the value of a country's currency. With the Smithsonian Agreement an attempt was made to add more flexibility to exchange rates by widening the band at which central banks would be forced to intervene. However, because the amount of capital that can move between countries now is so massive, market forces earlier this year pushed exchange rates through their wider bands; consequently most currencies were forced to follow Canada's example in abandoning the fixed exchange rate system.

Under this floating currency arrangement central bank intervention in support of currency values takes place on a much more limited scale, and speculators are dealing more directly with other speculators than with central banks.

I might add here a personal observation, that this frequently leads to a head-on battle where one group which has more ammunition at their disposal, will overwhelm the other by sheer strength and determination of purpose in total disregard of basic economic factors.

The use of floating exchange rate was not done on any systematic basis with the exception of the joint European float, and should not be considered as a new monetary system. As we have seen in recent weeks, this approach is by no means free of complications. Without greatly improved cooperation among the governments' major countries in the formulation of domestic economic policies, it is difficult to see how exchange rate crises can be avoided in the future. This appears to be a difficult goal to attain. A new set of rules to guide the international monetary system is necessary to help reduce the extent of instability in foreign exchange markets of the last 2 years. While foreign trade and investment have grown remarkably well in this period, there is serious concern as to whether this can continue under these conditions much longer.

To prevent major currency crises, however, it is necessary to incorporate in the formulation of these rules methods to reduce barriers to international trade and investment. This is particularly important now since during the past 2 years most major countries have increasingly turned to controls to insulate their domestic economies from international instabilities. A continuance of these barriers over the long run will only lead to further international financial turmoil.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Leclerc follows:]

Prepared Statement of Robert F. C. Leclerc

The Effects of Floating Exchange Rates on International Trade and Investment and Central Bank Support Operations

It is difficult at the present time to see an early end to the instability in foreign exchange markets. Recent periods of currency turmoil, however, appear to stem more from non-economic factors than fundamental economic conditions. The present climate in the international financial system is such that favorable news tends to be discounted while negative news is magnified. Under these conditions of international monetary instability, the introduction of floating exchange rates seemed to be the only alternative available. Even so, the existence of more flexible exchange rates has not removed all of the fundamental problems underlying the international monetary system.

Within foreign exchange markets, many observers find it hard to understand how the joint European floating of their currencies against the dollar will calm speculative pressures. In many respects, it is surprising that the European joint float has held up so well. In these times of currency uncertainty it seems unlikely that six major countries can keep their exchange rates moving together within a narrow 2¼% band. But, this has occurred so far. However, the longer the dollar continues under pressure the greater will be the strain on the joint currency arrangement.

It is further surprising that international trade and investment have not decreased during the last two years of currency crises with volatile and floating exchange rates. The continuous expansion of world commerce thus far, even under such circumstances, runs contrary to traditional thinking, which suggests that fixed exchange rates are required if world trade and investment are to expand. However, wider spreads and higher forward cover costs will likely result in higher

prices on goods exchanged in international commerce. There is some concern as to how much longer trade and investment can continue to expand in the face of mounting currency uncertainty.

Although immediate currency problems appear overwhelming, we cannot lose perspective nor neglect the more basic problems underlying the world monetary system. Since 1971, when the United States officially suspended the convertibility of the dollar into gold and devalued the dollar the first time, it has become widely accepted that the international monetary system was in need of fundamental reform. International financial problems have been emerging for many years, although only in recent years have they become unmanageable. The difficulty is directly related to the improper functioning of the old Bretton Woods system of balance-of-payments adjustment. Under this sytem the value of all foreign currencies was defined in terms of the dollar which was fixed in value. This system functioned well as long as the United States was the sole dominant economic power. However, as the war-torn economies of Europe and Japan began to recover and compete, the world economy changed and the dominance of the U.S. economy lessened.

The higher rate of economic performance of the new economic powers was reflected in growing U.S. balance-of-payments deficits. Nevertheless, no reform action was taken in the sixties in part because U.S. balance-of-payments deficits provided the financial support for the expansion of trade in a world short of liquidity. Symptomatic of these more fundamental problems, the U.S. balance-of-payments deficit continued sizeable and resulted in an accumulation of large amounts of dollars by foreign central banks which precipitated currency crises beginning in 1971. These crises were aggravated by the growing unwillingness of chronic trade surplus countries for political and economic reasons to adjust their exchange rates upward. This was especially true during periods of economic slowdown and growing unemployment which was the situation in Europe and Japan in 1971. Thus, a root cause of instability in exchange markets during recent years can be found in the failure of the international monetary system to adjust to the changing structure of the world economy.

It is difficult to determine to what extent the slow progress toward reform of the international monetary system is adversely affecting confidence in the dollar. The key issues confronting international monetary reform today are in essence the same as those that confronted the Bretton Woods conference in 1944. The first issue is the rapid movement of large amounts of capital between countries. These flows of capital are often the result of changes in a nations' domestic monetary policy which precipitate interest rate differentials as well as to create currency speculation. The attempt by a country to control large capital movements by changing exchange rates or allowing their currency to float before there has been a major effect on our nation's international reserve levels has not worked.

In the past, the response to massive capital flows was to defend the existing exchange rate parity at almost all costs and only as a last resort to change the value of a country's currency. With the Smithsonian Agreement, an attempt was made to add more flexibility to exchange rates before a government was forced to intervene with support operations. The floating of the British pound in June 1972, was an example of this new thinking. However, because the amount of capital that can move between countries now is so massive, market forces early in 1973 pushed exchange rates through their wider bands. Consequently, by early 1973 most major countries had been forced to follow Canada's example in abandoning the fixed exchange rate system in favor of floating exchange rates. Six of the European Common Market countries agreed to jointly float their currencies relative to the dollar.

Under this floating currency arrangement central bank intervention in support of currency values takes place on a much more limited scale than in the past, and the possibility for an exchange rate gain due to a change in a country's central rate no longer exists to the extent it did prior to March 1973. This is so because under the present situation of floating exchange rates, speculators are dealing more directly with other speculators than with central banks. The use of floating exchange rates was not done on any systematic basis,with the exception of the joint European float, and should not be considered as a new monetary system. Finally, as we have seen in recent weeks, this approach is not free of complications.

A second major issue confronting international monetary reform concerns the balance-of-payments adjustment process—the process by which deficits or surpluses are corrected. Greater exchange rate flexibility should make it easier to cope with temporary balance-of-payments disturbances and to recognize

fundamental deficits. However, it is extremely difficult economically and politically for a government to upvalue its currency when it is running a persistent balance-of-payments surplus, altough there is less reluctance to devalue given assurances that competitive devaluation by others will not follow. While floating a currency does seem to reduce speculative pressures, it nevertheless tends to make business transactions more difficult and costly. Furthermore, balance-of-payments adjustment problems are not only related to exchange rate levels, but also are closely tied to the existing levels of tariff and non-tariff barriers to trade. Therefore, any meaningful adjustment to remove balance-of-payments disequilibrium must include tariff negotiations as well as a modification of exchange rates and greater exchange rate flexibility. Since such negotiations appear to be more difficult, capital controls are likely to remain in effect. In light of these problems, a positive contribution to the adjustment process would result if more attention were given to the international ramifications of national economic policies and the formulation of the monetary-fiscal policy mix.

These problems provide a growing urgency for international monetary reform. The lack of a set of effective rules forced the United States to take the initiative and devalue the dollar on February 12. Leading Administration economists recently stated that this devaluation was the last. They have implied that import surcharges may be used instead, if the U.S. trade deficit does not improve from the devaluation of the dollar. Indeed, another significant devaluation of the dollar in the immediate future no doubt would only contribute further to uncertainty in an already shakey atmosphere and may result in other countries taking offsetting measures.

It is difficult to determine to what extent the slow progress toward reform of the international monetary system is adversely affecting confidence in the dollar. In the past, the International Monetary Fund—the agency through which governments manage the international monetary system—did not provide a process through which exchange rate adjustments could be made smoothly. Only through *ad hoc* international consultations and financial agreements between monetary authorities of major industrial countries was the international monetary system able to weather every crisis prior to 1971. Indeed, to some extent the Bretton Woods system obscured the developing fundamental world disequilibrium which precipitated the currency crises of the last two years.

The establishment of a new international system will not guarantee stability in the exchange markets. No matter how ingenious the new set of rules, they will not prevent periodic exchange-rate instability. Much emphasis has been placed on the need for improved cooperation among the governments of major countries in the formulation of domestic economic policies if exchange rate crises are to be avoided. To expect this to hapepn, however, is unrealistic, since neither the United States nor any other country has shown any willingness to make international monetary considerations a primary factor in setting its monetary or fiscal policies. Politically and economically, domestic economic considerations relating to unemployment, inflation, and economic growth will continue to dominate individual countries' economic policies.

A new set of rules to guide the international monetary system is necessary, however, to help reduce the extent of instability in foreign exchange markets in the last two years. While foreign trade and investment have grown remarkably well in this period, there is increasing uneasiness as to whether this expansion can continue under these conditions much longer. Unilateral action on the part of the United States in the form of devaluation provides only a short-term respite to allow the implementation of more concrete economic measures.

To prevent further major currency crises, however, it is necessary to incorporate in the formulation of these rules methods to reduce barriers to international trade and investment. This is particularly important now, since during the past two years most major countries have increasingly turned to controls to insulate their domestic economies from international instabilities. A continuance of these barriers over the long run will only lead to further international financial turmoil.

Chairman REUSS. Thank you very much, Mr. Leclerc.

Senator Javits.

Senator JAVITS. As I may have to go to an executive committee meeting of the Labor and Public Welfare Committee where I am the ranking member, may I express for the record two questions? Then, when you are all through with your oral statements, even if I am not here, will you be kind enough to answer?

The first question relates to the operations as you see it by the multinational corporations in currency, as contrasted with their normal business operations. What is your opinion and what backing do you have by way of evidence, that multinational corporations are or are not engaged in currency speculation under the guise of requiring forward coverage of foreign exchange for the purposes of their business?

My second question is—and we are faced with this in the Congress in a very immediate way—do you believe that we should have an agreement on international monetary reform prior to, simultaneous with, or after a trade agreement?

I won't interrupt the flow of your testimony but I would greatly appreciate those replies when you are through.

Thank you very much.

Chairman REUSS. Thank you, Senator.

And gentlemen, I see you have all noted this. And when we have fulfilled the testimony, I think I will ask you to respond to Senator Javits' two questions.

Senator Percy, we have heard from our first three witnesses. And we will now call on Mr. Prud'homme.

STATEMENT OF H. P. PRUD'HOMME, GENERAL MANAGER, BROWN BROS. HARRIMAN & CO., PRIVATE BANKERS, NEW YORK, N.Y.

Mr. PRUD'HOMME. Thank you, Mr. Chairman.

I also want to thank you for allowing me to present my views to the committee along with my colleagues from the banking and business communities. I am glad you are soliciting so many opinions from the private sector in these hearings. I am not sure that this has always occurred in previous hearings of this sort.

I don't really propose to review the points in my prepared statement today. But I should perhaps just list my three main conclusions. First, it is too early to be certain which exchange rate mechanism has been more or less beneficial to international business in an overall sense. In fact, I am a little doubtful that we should view this as an either/or situation. In the real world it is not quite so simple, and both mechanisms have advantages and disadvantages.

Secondly, the longer fluctuating rates are in existence, the more likely it is in my opinion that uncoordinated and perhaps competing national controls, including exchange controls, will be imposed. And if so, such controls will in due course not only impede the normal flow of transactions in themselves, but there is the added possibility that the very atmosphere of increasing controls will dampen enthusiasm for the expansion of international business overall.

Thirdly, as long as there is a commitment to floating rates, accompanied by controls, I feel there should be less strong or continuous commitment to market intervention by the central banks than existed under fixed rates. This in fact has been the case so far. It is very difficult to imagine guidelines which will cover all eventualities for a large number of central banks, or even for a few.

These conclusions are perhaps too bluntly stated. I shall be glad to elaborate further during the question period.

For the remainder of my time I should like to briefly review what has been happening in the markets and to comment on the effect of

the float or international business. In this you will hear some echoes of what my colleagues have already said.

I think the recent float can be divided into two periods: March and April, and May through June. In the first period relatively little happened; so little, in fact, that there is just not much to say about it, except that rate movement reflected some unwinding of positions taken in the February–March period of crisis, combined with the normal settlements on trade and investments and arbitrating on interest rate differentials between countries. The atmosphere during this first period was calm, and the markets in my opinion worked quite normally.

However, in the second period, starting in the early part of May, things were quite different. The dollar has weakened dramatically. Other rates have shot up to unrealistic levels. The dollar values of some of the major countries have moved as much as 3 percent or 4 percent in a few days. And collectively the major currencies now stand about 8 percent or so above their March levels on a trade weighted basis.

For rates such as exchange rates, which are quoted in tenths or hundredths of a cent, these are very large and sudden movements. Forward quotations have responded similarly with even wider swings, as the other members of this panel have noted. The margins between bid and offered quotes have widened as well. The net result has been erratic rates and overall thinness and fragility in the markets, and a change in the tone of dealings.

Now, some would argue that these things, and worse, would have occurred with fixed rates, given the circumstances of the last few weeks. That is probably true in the short run. But if sentiment does not change fairly soon, even the floating mechanisms may lead to abberations and beggar thy neighbor policies on the part of governments taking actions to protect their domestic economies, standards of living and employment levels. My own fear is that further controls will appear in the months ahead.

Others may say that if only the key currency, the dollar, were stable, there would be a more fair test for the floating mechanism, and conditions might have continued as in March and April. This is probably also true to a degree. But I feel that sooner or later some sort of testing would have occurred somewhere in the world. And if the dollar had remained stable, fixed rates would have served just as well as floating rates.

Could it be that the real problem of the past few years is the performance of the U.S. economy and of the standing of the dollar as the key currency in the monetary system, rather than the particular workings of the exchange rate mechanisms?

Turning now to the behavior of businessmen during recent weeks, I can only say that the uncertainties and tensions under which they have been operating have been no less than during crisis periods with fixed rates; perhaps more, because the number of variables and uncertainties have become greater, and there is no quick solution or resolution to the present situation in sight. Some speculative transactions may have been held in check by the strong upward movements of currencies. But a price has been paid. And it has been paid largely by those who are honestly trying to conduct normal commercial operations to improve their foreign markets and profits, and in the

process to make the U.S. more competitive and our balance of payments deficit somewhat smaller.

Wide swings in currency values have made the risk of being wrong much greater, added increasingly to the cost of normal insurance on hedging foreign exposures, and have forced business managers to shorten their horizons to the point where they are living on a hand-to-mouth basis.

To the extent it remains difficult to see or plan ahead with reasonable assurance, certain longer term and quite desirable transactions or types of transactions may soon begin to be impeded as well.

As you no doubt heard yesterday, corporate financial officers are caught in several binds. A company with large overseas operations cannot switch its assets around quickly, even if this were desirable, in response to changes in economic and political factors. In contrast, a bank trader may do so almost at will.

Also, exchange controls—which have grown much more numerous under floating rates—limit the flexibility to move funds from one center to another in response to changing conditions. Some controls, like our own OFDI regulations, have forced companies out into the international markets against their will. I believe that the borrowings of American corporations which relate to OFDI regulations may total something like $15 million at present.

Now that these companies are out in the international market as borrowers, they find their profit and loss accounts exposed to large swings in exchange rates from one accounting period to the next. And meanwhile the accounting profession is so divided on the correct way to translate foreign financial statements into dollars, for reporting to shareholders and the public, that distortions are created. Frequently, hedging decisions are made to conform to accounting and reporting requirements rather than to changes in the basic economics of the business.

To sum up, then, I would say that floating rates have been working only moderately well so far. In periods of tension or disequilibrium they have only been marginally better than fixed rates. They will probably spawn new controls in the future. My conclusion is that the better elements of each exchange rate mechanism should be retained. The monetary system of the future should be based on the agreed norms and rules of behavior which characterized the fixed rate system, coupled with the flexibility to make more frequent, but perhaps less large, adjustments which characterizes the floating system.

I hope this committee will support this position, and urge our negotiators to consider it as they proceed with their task.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Prud'homme follows:]

Prepared Statement of H. P. Prud'homme

Question 1. Has the introduction of a fluctuating exchange rate mechanism—as opposed to the earlier more-or-less fixed rates—facilitated or impeded international trade and investment transactions?

I will attempt in this statement to provide the practical bankers' point of view, and in so doing, wish to express my personal belief that the most desirable monetary arrangements for the future will consist of a melding of the benefits of agreed rules and norms of international behavior, which characterized the fixed rate system, with the flexibility of the floating rate mechanism. This seems to be the direction in which most governments, including the United States, are moving in

their negotiations through the Committee of Twenty. I think they are on the right track.

Taken as a whole and to date, I believe floating rates have neither facilitated nor impeded international transactions to a significant extent. If anything, they have, so far, put limits on some speculative flows of funds which, under similar circumstances, might well have occurred with fixed rates. In this sense, it may be that certain unwanted or undesirable transactions have been impeded.

But, in another sense, a price has been paid. Floating rates seem to encourage the use of exchange controls, and they have certainly led to relatively wide swings in exchange values over short periods of time. These factors have already created new problems and uncertainties for businessmen. They now find that the conduct of necessary business is subject to frequent market risk and that long-range planning is more complex. To the extent it remains difficult to see or plan ahead with assurance, it may be that certain desirable types of transactions will soon begin to be impeded as well.

In support of these conclusions, I should like to submit five points for more detailed discussion:

1. There is obviously much more post-war experience with the fixed rate mechanism than with floating rates. In fact, the international markets have only about nine months of experience with generalized and widespread flexibility (August–December 1971 and March–June 1973). During these periods, almost no rules have been established for the guidance of governments, nor have reliable precedents been developed in the exchange markets.

Because the floats have been so brief, it is still easier to prove the deficiencies of the "old" fixed rate mechanism than to be sure of the practical efficacies of the "new" mechanism. Many would argue that in the past few weeks, the new mechanism has been subjected to a severe test and that the float has demonstrated its resiliency and ability to function. This is clearly encouraging, but it does not yet give me full confidence in the new mechanism. In the first place, both the 1971 and 1973 floats occurred very soon after devaluations of the dollar. It is difficult to distinguish between the effects of the devaluations of the key currency—followed in both instances by further weakness of the dollar—and the workings of the floating mechanism itself. In short, it is too early to draw general conclusions from the particular circumstances and brief periods in which the floating has occurred.

2. It is well to remember that neither the Bretton Woods system of fixed rates nor the 1971 and 1973 experiences with floating rates have been "clean" or "pure". Both have been "dirty" in some respects. (In this context, the word "dirty" refers primarily to exchange controls and capital market restrictions which are designed to prevent or limit transactions in specific ways.) Neither exchange rate mechanism, unaided by controls, was felt to be adequate to the problems inherent in international capital flows, especially short-term capital flows. In recent years, such capital flows have grown enormously, and have often overwhelmed the substantial trade-related flows. While trade has prospered from the liberalization of barriers, the growth of capital flows has been paralleled by the imposition of new controls.

Under the floating system, virtually all of the old capital controls have been maintained and several conspicuous new ones added. On present evidence, it appears that floating rates could lead to a further proliferation of controls. Our foreign partners, whose economies are much more sensitive to external influences than our own, have simply not been prepared to subject themselves fully to floating exchange rates.

3. It must also be recalled that floating rates were not introduced as a new system of international monetary cooperation, but as an expedient when other alternatives failed. For brief periods, the markets have behaved fairly normally, but when uncertainties have arisen, as in the last month or so, exchange rate movements have tended to become larger, the margins between buying and selling rates have tended to widen, and forward rates have also experienced greater swings than were generally anticipated. It is doubtful that these developments are helpful or profitable to international companies (the exporters and investors), who are not in a position quickly to undo contracts for the purchase or sale of raw materials and goods and who cannot adjust their foreign assets positions like dealers in the foreign exchange departments of banks. Those with long-term commitments abroad are at a disadvantage.

Furthermore, flexible exchange rates have not improved the functioning or tone of the exchange markets for any of the direct participants. In the uncertainty prevailing today, the overall volume of transactions has tended to decline, and the

markets are thin and erratic. In such circumstances, it has become increasingly difficult to execute large commercial transactions, and in trying to do so, the costs are easily increased. These comments are particularly applicable to the condition of the forward (or futures) market.

4. There is an important (and often hidden) question in comparing the two mechanisms: From whose point of view have fixed or floating rates been working well—that of the world economy, that of national governments and their treasuries, or that of the extremely diverse entities known as the "private sector"? An efficient monetary system should aim to balance the needs of all three to the extent possible. With respect to the needs of the private sector, floating rates have *already* considerably changed the economics and risks for those engaged in international business, especially those who trade, invest, and operate across a number of borders and whose activities are subject to several jurisdictions.

Discussions of floating rates often assume that under such a mechanism, gains will balance losses in the end, as exchange rates rise and fall in response to real changes in conditions and as market forces push the rates toward equilibrium levels. In the long run, this might well be true, both in theory and practice, but it is probably only true in the aggregate. In a way, the floating mechanism relieves governments and monetary authorities from carrying their full share of the responsibility in making sure that the mechanism works efficiently. It throws most of the responsibility on to the private sector, including both banks and their customers. I am not convinced that the private sector is able to accept all of this responsibility. The lack of a strong stabilizing force can lead, as we have seen, to erratic movements in exchange rates and the dominance of psychological or emotional factors.

An individual company has specific trade and investment needs at specific times. For individual firms, there is no assurance from one accounting period to the next that exchange gains will balance losses in their particular cases. Short of selling off its foreign operations, a cmpany has no option in a floating system but to have its foreign assets and operating income subjected to unsymmetrical market risks. Usually these risks are brought about by factors well beyond the individual company's control. Some of them may turn out to be quite transitory. The geographical mix of a company's foreign operations is important, too, and in the short-term it is not usually possible to relocate sources of supply or to relocate manufacturing operations.

Given (a) the magnitudes of possible exchange rate fluctuations, (b) the necessity of rendering financial statements at regular intervals, and (c) corporate responsibilities toward shareholders, flexible rates may lead to the temptation to make "quick turns", or to tendencies to avoid risks by staying hedged or insured at all times, without due regard to the costs. There may also be a tendency to overemphasize the exchange risk factor in long-range planning or in the location of production facilities.

5. There are accounting factors which enter into business decisions and corporate hedging strategies which a floating rate environment exacerbates. Accounting problems cannot stand in the way of monetary reform, but until they are resolved, they will have an additional and sometimes distorting influence on corporate behavior and on exchange rates. During the past few years, there has been no agreement in this country on the most appropriate way to translate foreign subsidiary assets and liabilities into dollars when preparing consolidated financial statements. There are roughly three principal methods now in use, each with advantages and disadvantages. The lack of agreement on accounting principles and the diverse interpretations of the results may lead to confusion, particularly when public reporting is becoming more complete and more timely. Regardless of the accounting system one chooses, there are implicit as well as explicit effects on income statements of changes in asset values and revenues when exchange rates float up or down. Thus, floating rates may lead to overly frequent adjustments in financial statements from quarter to quarter, and will affect hedging strategies in anticipation of such adjustments. These adjustments can be unrelated to the underlying business and productive capacity of the enterprise, or the ability of investors to judge how well a company may be doing. Until our accounting principles are much more clearly defined—and they vary widely not only from company to company and industry to industry, but also from country to country—floating rates will be a distorting factor.

With this background, it can be seen why I believe it may be too early to be certain which exchange rate mechanism has been more, or less, beneficial to international business in an overall sense. The periodic crises of the old fixed rate system are a matter of clear historical record: fixed rates which were maintained

too long became fixed targets for speculative trading activity in periods of uncertainty. But the world moved on during the fixed rate period, and international trade and investments grew at a faster and more sustainable pace than at any other time in history. On the other hand, even if one admits that the new floating rate mechanism has not measurably impeded the growth of trade and investments to date, it has introduced a different set of uncertainties. No breakdown has occurred, and short-term transactions have continued in spite of sharp movements in rates. However, many corporate planners and investors are confused and uncomfortable when considering the longer term outlook. There are indications that long term borrowing and investment decisions are being made extremely difficult, both because of exchange controls and the virtual impossibility of making long-range predictions for currency values when considering the costs and profitability of new projects.

Question 2. Is the impact of fluctuating rates likely to change significantly when the mechanism is in place for a longer time?

Regardless of how one views fixed versus floating mechanisms at this stage, and until we know the real shape of the reformed monetary system now under negotiation—say, 2 or 3 years hence—we must live with the anomaly of floating rates accompanied by controls. I see no satisfactory way to return to fixed rates soon, certainly not before the U.S. balance of payments is much closer to equilibrium. In the meantime, we may well see some further strains on the monetary system, strains on the cooperative spirit for trade and monetary reform which exists between the major governments, and an occasional escalation in "dirtiness" which no one really wants but which many countries may feel powerless to avoid.

Such an outlook may seem bleak, but I do not feel it should be viewed as being all bad. Rather, in learning to live with the fluctuating mechanism, the focus should be on what can be learned from the experience. To achieve a well-balanced monetary system, there has got to be some further experimentation with the float. And it should be noted that one of the reasons the floating has worked as well as it has is that so many parties are agreed that it is only a temporary phase. In other words, the present functioning of the floating mechnism is based in large part on the premise that it will be done away with relatively soon. This expectation pervades not only the thinking of monetary officials, but also is clearly in the minds of the major operators in the exchange markets. Thus the float may be appropriate during this interim period of unusually far-reaching changes in trade and monetary arrangements; however, it would be quite another thing if the float were to be made permanent.

I personally believe that the longer fluctuating rates are in existence, the more likely it is that uncoordinated and perhaps even competing national controls will be imposed. Incidentally, these controls may be applied not only to the foreign exchange markets, but also to the closely related Euro-currency markets.

When it comes to controls, governments have shown themselves to be ingenious. They impose specific prohibitions, such as the restrictions on foreign borrowings by German companies and restrictions on the purchase of German securities by foreigners, or the negative interest charges levied on foreign deposits in Switzerland; they allocate resources, as when companies are required to obtain approval for borrowings and are then forced to queue up when bringing issues to market; they attempt to separate current and capital transactions by maintaining dual exchange rates as in Belgium, France, Holland, and Italy; they provide guidance as to which types of transactions are appropriate or preferable and which are not, as in England; and they require participants in the markets to provide increasingly voluminous reports on their transactions so that day-to-day activities may be closely monitored. Such direct and indirect controls may be "voluntary", they may be applied (or changed) by administrative decision or interpretation, or they may be explicit in the form of written laws or regulations. They may be accompanied by other types of "controls", such as taxation, which can inhibit or discourage many types of transactions.

The exchange controls which were in place under the fixed rate mechanism were in most cases designed to keep funds *in* a country, to protect its balance of payments and reserves. They are almost always described as being "temporary", such as our own Interest Equalization Tax, Voluntary Foreign Credit Restraint program, and OFDI regulations. When the major currencies were forced to float in August 1971, and again earlier this year, new controls appeared which were often as not designed to keep footloose money *out* of a country. It seems to me that the latter action is potentially more aggressive than the former, and is more subject to the danger of becoming competitive. Both types of controls still exist

in many countries, and it will be difficult to get rid of them. There is also no assurance that countries which may have relaxed controls now and again will not reimpose them at will, almost from one day to the next.

I submit that in due course such controls will not only impede normal transactions in and of themselves, creating some market distortions along the way, but there is the added possibility that an atmosphere of even moderate escalation in controls would begin to dampen enthusiasm for the expansion of international business in general.

Let me also add, however, that one good way to minimize the dangers inherent in the floating mechanism is to work as quickly and determinedly as possible toward restoration of the dollar's strength. This process is bound to take time. It is, no doubt, subject to temporary lapses. But it is a necessary ingredient if further crippling exchange controls are to be avoided, and if central bank intervention is to be kept within well-defined limits.

Question 5. What sort of guidelines should be established to regulate central bank intervention in exchange markets?

This question relates to the direct intervention of central banks in the exchange markets through the deliberate execution of transactions with the private sector of the market, rather than intervention through exchange controls. Obviously, the nature of such intervention will depend on whether fixed, adjustable, or fluctuating rates are in use.

The usual reason given by central banks for intervention is "to maintain orderly market conditions". This implies two or more central banks working together; such actions may also be considered "dirty". Under the floating system, there is the implied supposition that the mechanism itself will not always result in orderly markets, no matter how defined, so the question becomes: How is it possible to sanitize dirty floats?

Conversely, under the fixed rate system, experience has shown that on some occasions central banks have gone much further than maintaining orderly conditions. They have sometimes tried to prevent or postpone parity changes, or to hinder flows of funds which were thought to be draining or adding too quickly to their currency reserves. As a practical banker, I cannot escape the thought that in the past the manipulation of rates through intervention has sometimes been politically motivated. Nor is there much proof that monetary authorities have a good way of distinguishing between brief flurries in the markets and fundamental disequilibria in their balance of payments.

Clearly, under present arrangements, new guidelines are required with respect to direct intervention. I feel that as long as there is a strong commitment to experimenting with floating rates, there should be a less strong or continuous commitment to market intervention. In the long run, the best form of "intervention" will be for each country to get its fundamental economic position right, rather than to attempt exchange rate equilibrium.

Other than the above, I have few specific suggestions as to the guidelines which should be established for central banks. In principle, I would prefer that some sort of international vehicle, perhaps a rejuvenated International Monetary Fund, would assemble an international body of experts constantly to review, define and enforce rules of conduct, both with respect to direct market intervention and exchange controls.

I do not think there is any one set of rules which could or should be applied, nor do I think the Committee of Twenty is a suitable forum for trying to establish more than the most general framework of appropriate national behavior. There is a long period of recuperation and evolution ahead for the monetary system and the dollar. Both political and economic circumstances change too much, too frequently, and too unexpectedly to warrant absolute rules or to keep specific guidelines up-to-date, even among the fifteen or twenty most influential nations.

Chairman Reuss. Thank you very much, Mr. Prud'homme.

Mr. Teck, please proceed.

STATEMENT OF ALAN TECK, VICE PRESIDENT, CHEMICAL BANK, NEW YORK, N.Y.

Mr. Teck. Events since mid-March have indicated that the recently created system of foreign currencies floating against the dollar is working surprisingly well. This arrangement appears better suited to the current environment than any of the previous systems and

probably better than any of the alternatives presently under discussion. Banks and other types of businesses seem to be adjusting quickly and easily to the present foreign exchange arrangements, and recent experience suggests that any further changes that might be required by a prolonged float will probably be relatively minor.

Before turning attention to the few areas in which banking and corporate activities have been altered, and before commenting on suggestions for central bank guidelines for intervention, one general observation about international trade may be useful to place some recent developments into a broader perspective.

From a worldwide viewpoint there is no reason to believe that floating exchange rates will, or should, reduce the volume of trade. However, as Fritz Machlup points out in a recent issue of Euromoney, it is easy to see how such an idea got started. It was created and reinforced by the experience and complaints of individual exporters and importers. But when imports and exports are considered together, there is no apparent relationship between floating rates and the overall volume of trade. If the U.S. dollar strengthens, for example, the United States may export less and import more. However, if the dollar weakens, we may export more while importing less. Thus, while the effects of changing rates may fall unequally on individual exporters and importers, the impact on the overall activity may remain fairly constant as imports and exports become alternatively attractive.

During the past decade, a period in which there was considerable monetary upheaval, due largely to the inability of the Bretton Woods system to adapt to a rapidly changing environment, the volume of world trade tripled—from 1962 through 1972—with increases in every year. In fact, the value of world trade advanced by 12 percent in 1971 and 17 percent in 1972, the years in which the greatest monetary upheavals were occurring, with substantial annual gains in real terms as well.

To the extent that one can draw inferences from Chemical Bank's experience, international trade has continued to expand since the floating markets reopened in early March.

As you know, a good part of international trade is financed with letters of credit, banker acceptances, and direct payments handled in foreign collections departments. It is interesting to note that since March of this year Chemical Bank has experienced no significant changes in either the volume or the number of transactions handled in those departments, except for a continuation of a normal growth trend. To the extent that Chemical Bank's experience is typical, the amount of financing of international trade, and therefore the underlying trade itself, has certainly not declined and may well have increased slightly since the advent of floating exchange rates.

Within the context of this modest expansion there is one trend that may be worth noting. Namely, there has been a sharp increase in the number of invoices denominated in currencies other than U.S. dollars, primarily in the stronger currencies: Deutsche marks, Swiss francs, and yen.

As this has occurred there has been an increase in our bank's foreign exchange activity. The number of transactions rose by 12 percent from March to May compared to the same period of 1972, and the dollar value of such transactions advanced at approximately the same

rate. However, when one studies the breakdown of these transactions, it is immediately apparent that all of the increase occurred in categories related to the sharp growth in the number of invoices being denominated in foreign currencies; that is, currencies other than dollars, and not as some have suggested, in areas that represent banks and corporations taking larger and more frequent positions for either protection or speculation.

A second point that has been discussed with some frequency lately concerns the allegedly wider spreads between bid and offer quotations in the foreign exchange markets since the advent of the float. It is by no means clear that such a widening has occurred. When the dollar started to float and was fairly stable from mid-March through early May, spreads between bids and offer quotations were fairly narrow in the foreign exchange markets. These spreads widened rather dramatically about mid-May as the dollar started to weaken and increased uncertainty entered the markets. However, even today's spreads in both the spot and forward markets for most currencies are less wide than during many periods of uncertainty under the Bretton Woods system. The early evidence indicates that increases and decreases of spreads between bid and offer quotations are not a function of floating versus nonfloating, but rather a function of the degree of uncertainty and instability in the markets. And as we know from the period from late March through mid-May, floating markets do not necessarily imply either uncertainty or instability.

Third, under the Bretton Woods' fixed-rate system there was often an incentive to acquire a position in a currency when it was at its ceiling and pressure was clearly upward, or at its floor with pressure clearly downward, and wait for the parity change. Under floating rates there is a measurably greater reluctance to acquire such positions, because the possibilities for two-way movements usually carry the risk of unacceptable losses if the trader tries to maintain such positions while also actively trading. Early evidence suggests that floating rates may have reduced the incentive to acquire constantly long or constantly short positions, a development which many observers consider favorable.

Three other areas of bank activity, investing, lending and borrowing, have remained virtually unchanged by the advent of floating rates. Certainly no difficulties have developed which might impede banking activity or the further growth of international trade or investment.

Part of my activities as head of Chemical Bank's Foreign Exchange Advisory Service is to consult almost daily with U.S. and foreign corporations about the management of their foreign exchange exposure. In the past month alone I have discussed this subject with numerous multinational corporations in the United States and Europe. My overriding impression is that while many businessmen feel understandably uneasy as they enter the new environment, very few have done anything differently during the past 3 months as a result of the float. In almost all cases there has been greatly increased sensitivity to the fundamental problems associated with uncertainty, and many of the accounting operational and protection strategies that have been used throughout the post-1945 period have been employed with increasing vigor. However, no new techniques have

been added or significant difficulties encountered as a result of the float.

On May 15 of this year the International Federation of Associations of Business Economists held its first international meeting in Paris. At that time I made a speech entitled "Managing Foreign Exchange Exposure in an Uncertain Environment," which dealt with many of the techniques used by corporations to increase their opportunities for profit as well as their protection in periods of uncertainty. With your permission, I would like to submit that speech for inclusion in this committee's records.

Chairman REUSS. Without objection, it will be received into the the record at this point.

[The speech referred to follows:]

MANAGING FOREIGN EXCHANGE EXPOSURE IN AN UNCERTAIN ENVIRONMENT[1]

About three months ago, when I was asked to prepare today's remarks, it was requested that I try to discuss fundamentals rather than events that might be of current, but merely transitory, interest. In this context, I have taken the liberty of modifying the assigned title from the rather awesome "Monetary and Exchange Rate Outlook and Implications to Industry" to "Managing Foreign Exchange Exposure in an Uncertain Environment". This, I think, more correctly reflects two basic facts: First, that not only the past few months but also the entire post-1945 period has been marked by frequent changes in the parities of virtually all currencies—to say nothing of the wide and often unpredictable variations in spot and forward rates. And second, that businessmen engaged in international activity have not spent this period passively watching their foreign currency assets and liabilities rise and fall in value as currency rates fluctuate. Quite the contrary, businessmen have become increasingly active in applying accounting, operational and protection strategies to minimize their exposure to possible losses and in many cases to turn potential losses into gains when the anticipated currency movements occur.

POSSIBILITIES FOR EXCHANGE RATE MOVEMENTS IN TODAY'S ENVIRONMENT

Before discussing some of these strategies, it might be interesting to review briefly some of the possibilities for currency movements in the recent and present environment. Such a survey frequently reveals that the range of possibilities as well as the inherent risks and uncertainties are considerably greater than is generally realized.

First, as everyone knows, during the quarter century from 1946 to 1971 a series of developments occurred that resulted in virtually all nations, separately and in groups, periodically devaluing or revaluing their currencies, some as many as six or seven times, with single movements of between 10 or 40% by no means uncommon. Fluctuations in the forward rates were even greater. Further adding to the uncertainty of that period was the constant imposition and removal of a variety of increasingly complex controls designed to influence the movements of currencies, trade and capital.

In December of 1971, as everyone also knows, the IMF bands were widened so that spot rates could fluctuate by 2¼% on either side of parity rather than by the 1% previously in effect. Spot rates could then move by 4½% from floor to ceiling previously 2%, and cross rates between two currencies could shift by 9 instead of 4%. That development alone greatly increased the possibility for spot rates to respond to market conditions, but the potential for large, abrupt changes still remained as the new limits continued to impose barriers to the incremental pressures of market forces.

Then, in March of this year, additional changes occurred which broadened still further the range of possibilities for exchange rate movements, although the experience since March suggests that the greater flexibility under present conditions has probably increased the predictability of currency movements and reduced the risks of the type of sudden realignments that occurred so frequently

[1] Speech given to the International Federation of Associations of Business Economists in Paris on May 15, 973, by Alan Teck, Vice President, Chemical Bank.

under the Bretton Woods System—a point to which I will return shortly. While a few of the possibilities in today's environment are new, most of them have existed for many years. Let me provide a few examples.

First, a number of major currencies are now floating. Among these are sterling, the Swiss franc, the yen, the commercial and financial lire and the Canadian dollar. In the absence of central bank intervention these currencies can theoretically fluctuate from virtually zero to infinity relative to other currencies.

Second, there is a host of multinational agreements that a businessman must consider to correctly assess his currency risks. There is the well known "snake" whereby Germany, France, Belgium, Denmark and the Netherlands have agreed to maintain their cross rates within 2¼% of each other, while floating as a group against other currencies. (Incidentally, if one currency in the snake remains stable, the others can move from 2¼% above to 2¼% below that currency, thereby permitting movements up to 4½% even within the snake.) Additionally, Norway, Sweden and Finland have stated their intention of having their currencies move with the snake.

Then there are other combinations of international agreements. For example, there is the so called sterling block (or scheduled countries) which, even though it has been greatly diminished recently, still exists, including India, Ireland and certain African and Caribbean countries among others. There is the French Monetary Area, which also has been greatly reduced but which still includes a number of African countries. Nations in these groups maintain their parities and sometimes even their spot rates in fixed relationships to one another. Furthermore, there is what might be called an informal U.S. dollar block comprised of a number of currencies that tend to follow movements of the U.S. dollar. Most recently this included many Latin American currencies.

Further complicating the issue, countries can shift from one block to another and can also follow patterns that differ from the group with which they associate. For example, the Hong Kong dollar moved from the sterling to the U.S. dollar block when sterling floated in 1972, but maintained its parity when the dollar devalued in February of this year.

In addition to these special arrangements there is a variety of still other possibilities for currency movements. Some countries still maintain the original 1% IMF limits, while others now make use of the wider 2¼% bands. Some intervene only at the floor or ceiling; others intercede well before these limits are reached. Still other countries maintain rigidly fixed spot rates even though they maintain bands within which spot rates are theoretically permitted to fluctuate. Those spot rates are changed only in response to national political pressures. In Mexico, for example, spot has been held very stable at 12½ pesos to the dollar since 1954 despite the existence of 1% bands. Also Australia is presently maintaining a firmly fixed spot at 1.42 U.S. dollars per Australian dollar. South Africa is also in this category as are to some extent Spain and Portugal.

Somewhere between floating and fixed are the so-called crawling pegs. Brazil, for example, had a number of 2 or 3% devaluations for many years through 1972. But to make the matter even more confusing, it can be noted that Brazil had a 3% revaluation relative to the US Dollar in February of this year prior to a 1% devaluation in April.

Then, of course, in addition to many single-tier currencies there are two-tier systems with one tier, usually called the "official" or "commercial", permitted to fluctuate only within fixed bands (or within the snake as with the Belgian and French francs) while the financial variety generally floats with only minimum, if any, central bank intervention.

Additionally, there are what might be called "modified" two-tier systems. Argentina, for example, has a commercial rate which has been fixed at 20 US cents and a financial rate that has been fairly stable at about 10 cents since the second quarter of 1971. But there have been a number of de factor devaluations resulting from the fact that many Argentinian exports and imports are handled at a composite rate, which at one time was, say, 25% financial and 75% commercial. This was then changed to, say, 50/50 and is now 24%/76% for some transactions and 10%/90% for others. Each of these changes in mix effectively devalued the peso that applied to many of Argentina's imports and exports.

There are also multi-tier systems. Some countries, for example, have official or commercial rates, financial rates and still other rates for exports and others for imports. Indeed, some countries even have specific rates for particular commodities: such as the coffee rate in Colombia or the oil export rate in Venezuela.

Still other countries have "unofficial markets": that is, rates that are quoted on a quasi-official or even unofficial basis. In the Philippines and in many countries

of Eastern Europe, for example, many commercial transactions are financed at rates determined in gray and black markets.

Probably enough examples have been provided by now to illustrate the point: namely, there is considerable diversity in the possibilities for exchange rate movements, and these possibilities have to be studied on a currency-by-currency basis. Moreover, in addition to changes in spot rates, many nations achieve the same effects as devaluations or revaluations by imposing or removing taxes or subsidies on selected import or export items. Frequently, certain countries will prefer to achieve a devaluation effect by lowering taxes or by rebates to manufacturers to avoid the inflationary impact that a devaluation would have on the cost of essential imports.

Additionally, some countries produce effective currency changes by moving commodities or services from one tier to another. Shifting an item from a commercial to a financial French franc, for example, will produce a de facto devaluation or revaluation depending on the relative levels of each tier.

Lastly, most currencies in the world are not actively traded at all. There is no active market, for example, for a Peruvian sol or Burmese Kyat. For these, and most other currencies as well, one must negotiate directly with a local bank and pay whatever rate is acceptable to both parties. Considerable rate changes can occur with each negotiation.

Faced with this range of possibilities, uncertainties, risks and potential losses—and I have mentioned only a few—one might think that business activity probably ground to a halt long ago. Not so. International trade was estimated to be $350 billion in 1972, 2½ times greater than it was decade ago, with an increase in every year. And U.S. foreign investment alone exceeded $110 billion in 1972, also about 2½ times greater than a decade ago. Early data for 1973 suggest that both world trade and investment are continuing to expand this year. Thus, businessmen must have learned something about how to deal with and perhaps even profit by foreign exchange fluctuations. It is to some of their methods and strategies that attention is now turned. This will be followed by brief comments about the international monetary outlook.

The Business Response

The primary focus in the following observations will be on non-financial corporations rather than on banks, other financial institutions or government agencies. While all of these organizations have similarities, they are sufficiently different to be treated separately for purposes of this discussion. The accounting and tax references will be from the United States experience; but these references are by no means unique. There are analogous possibilities in virtually every major trading country.

In the following remarks I would like to cover four points:

1. What gives rise to an exposure to gains or losses associated with currency fluctuations?
2. How is this exposure measured?
3. What can be done to reduce this exposure? And
4. What alternatives exist for protecting the exposure that remains even after it has been minimized?

First, what gives rise to exposure to gains or losses associated with currency fluctuations? The two most common activities are, of course, direct investment in foreign subsidiaries, branches or affiliates, and secondly, international trade in which receivables or payables are denominated in foreign currencies. In addition, exposure can arise as a result of a portfolio investment and when debt is incurred in a foreign currency.

Let us now look at some of the ways that this exposure can be measured. You can be assured that the corporate financial officer spends a great deal of time thinking about this with his accountants and auditors as he typically has wide range of alternatives that are consistent with generally accepted accounting principles in his country. And, as we shall see, a carefully selected method for calculating exposure can turn a potential book loss into a potential gain under exactly the same conditions. A few references to accounting conventions in the United States will provide some examples of what I mean.

Perhaps the most common U.S. accounting convention for measuring exposure is the so-called "net working capital" method: that is, exposure equals current assets denominated in a foreign currency less current liabilities denominated in foreign currencies after the exclusion of inter-company transactions. If current assets exceed current liabilities a book loss is realized in the event of a devaluation and a gain after a revaluation.

Another method for measuring exposure is called the "net financial" method. This is the same as the working capital method except that long-term debt denominated in foreign currency is included with the current liabilities. For most companies, the inclusion of long-term debt in the calculation of exposure can greatly reduce exposure and in some cases even turn an exposure to potential loss into an exposure for potential gain.

Another accounting procedure for computing exposure is the so-called monetary/non-monetary method. This approach, which has become increasingly popular in recent years, makes a distinction between the monetary and the physical items on the balance sheet, usually translating inventories at historical rates and long-term debt at current rates. In many companies, with inventories of 50 or even 75 percent of current assets, it obviously makes a considerable difference if inventories are included or excluded from exposure calculations.

Out of these and many other alternatives, the question is how does the corporate financial officer select the best method for his company? Theoretically, there are two basic criteria: realism and consistency. That is, the financial officer generally tries to select the method that is most likely to closely reflect the gains or losses that will actually occur if currency values change. But obviously there is considerable room for judgement within this conceptual framework, and many companies can significantly reduce and even reverse their book exposure by a judicious selection of accounting methods. Furthermore, while a corporation usually adopts a single, corporatewide method for computing exposure, there are circumstances that permit the application of different methods to operations in different countries.

Let us now assume that the most appropriate accounting methods are employed and turn attention to some of the operating procedures for further reducing or reversing an exposed position and for affecting the real or economic gains or losses by the timing of converting one currency into another.

It is generally good business practice, for example, to keep cash at the minimum level required for working capital, and this is particularly true if the cash is in a devaluation-prone currency. To minimize such cash internationally, the corporate financial officer will use all of the techniques employed domestically plus a few more. After forecasting his receipts and disbursements on a daily, weekly and monthly basis to estimate when excesses and shortfalls might occur, he will take steps to move excess cash to a central place either within a country or internationally, using techniques such as wire transfers, lock box systems, instructions to customers to remit funds directly to a specified country, and so forth. Methods will be developed for pooling funds within a country and internationally so that locations with excess cash can provide liquidity to those requiring cash. (Incidentally, many corporations pool their funds internationally by using the facilities of multinational banks which provide services that can frequently transcend restrictive national regulations.) The financial officer will also examine an entire range of possibilities for swaps or parallel loans among sister locations, as well as a whole host of well-known international money management techniques designed to minimize otherwise idle cash. In addition, of course, excess cash will be remitted to the parent company as rapidly as possible, except when the potential gains from an expected revaluation exceed the opportunity cost of holding idle cash.

Turning briefly to accounts receivable and payable, the techniques to minimize exposure are legion, mostly involving so-called leads and lags. When a devaluation threatens and competition permits, a company might try to denominate its invoices in a strong currency. If the corporate treasurer must bill in a weak currency, he will try to collect payment as soon as possible for conversion into hard currency, using all of the standard collection techniques employed domestically. He might increase his management and staff effort to reduce the time between receiving orders, shipping merchandise, getting out the invoices, and making collections. He would be prepared to give discounts for early payments as long as the discounts do not exceed the expected loss from devaluation. And, if competition permits, he might charge penalties on late payments.

With accounts payable in weak currencies, the financial officer is on the other side of the problem. When a devaluation threatens he will try to delay payments until the penalty costs or damage to credit ratings exceed expected losses. On the other hand, if a revaluation appears likely he might try to prepay and in some cases even preorder as was recently the case with many Scandinavian corporations that wanted ships that were to be made in Japan. Requirements were anticipated and ships ordered many months and even years before they were needed, and then many Scandinavian companies tried to pay for the ships immediately and even prepay in expectation of the yen revaluation that subsequently occurred.

Without going into further detail, one can readily see that there is a wide range of strategies for managing receivables and payables in anticipation of changing currency values. Each technique requires an intimate understanding of the business and circumstances involved as well as a thorough knowledge of the costs, alternatives, and estimated losses if existing methods remain unchanged.

Turning briefly to inventories: as a general rule inventories should be minimized in all ways that are consistent with maintaining the proper flow of work and providing finished goods to customers. This is true domestically as an effort is made to avoid tying up too much working capital and it is additionally true in countries where financial officers are trying to reduce an exposure to devaluation. However, in certain devaluation-prone currencies (which are usually in countries with relatively rapid inflation rates), inventories might be accumulated as a hedge if it is expected that prices on the goods to be produced can be marked up after the devaluation so that a higher profit margin will offset or more than offset the book losses. Here again businessmen have found many ways to accomplish their objectives. Corporations with operations in countries that do not permit prices to be increased after a devaluation have been known to mark up prices in anticipation of a devaluation, sell at a discount and then advance to the so-called "regular" price after the devaluation occurs.

Needless to say the strategies for managing inventories are as numerous as the operations, countries and circumstances involved. In all cases the relevant trade-off is between the expected gain in using inventories as a hedge versus carrying expenses and the costs of alternatives forms of protection.

Switching briefly to some current liabilities, protection strategies not only require that such liabilities be increased when a devaluation threatens but also that the corresponding gain in assets be converted into hard currency or invested in assets not subject to devaluation or which will be sufficiently productive to recoupe at least part of the expected foreign exchange loss.

Computing the costs and benefits of using debt as a devaluation hedge is not as easy as it might sound as in virtually every situation these ocsts and gains must be estimated. If, for instance, a rate is quoted as a percentage of a prime or base rate the financial officer must estimate what the prime or base rate will average over the life of the debt. In addition, he might have to consider the costs of compensating balances and other charges less the expected income when the cash is put to use and perhaps the local inflation rate or the expected devaluation. In the U.K. for example, the nominal cost of debt might be 10% per year. However, if a 5% devaluation (or downward float) is expected, the estimated pre-tax cost might be only 5%. Then, to make matters even more complicated, the anticipated cost has to be calculated on an after-tax as well as pre-tax basis to be compared to the cost of alternative forms of protection that will be mentioned in a few moments.

Clearly the discussion of operating strategies for minimizing exposure is endless. The overriding principle is that to minimize exposure the corporate financial officer must not only select the most appropriate accounting methods but also rigorously apply the appropriate operating techniques to each of his assets and liabilities, constantly evaluating the costs, benefit and alternatives of each action.

Let us now assume that after applying the most advantageous accounting and operating methods, the financial officer still finds himself with an exposure to possible losses. There are additional strategies that can be developed and other alternatives to be evaluated. One alternative, obviously, is to do nothing; that is to be self-insured. This option, as with all other alternatives, has a cost. If there is a change in the relative value of a foreign currency, a gain or loss will be realized according to the percentage change of the currency times the amount of exposure. If a loss occurs, it can be taken immediately or spread over time by the use of reserves; but in either case it must be absorbed. Self-insuring is an option frequently selected by companies with very high profit margins. These organizations usually treat devaluation losses as they would any other cost, indicating that they would not be doing business in devaluation-prone countries were they not prepared to absorb those expenses.

Another alternative, which has already been discussed, involves incurring weak currency indebtedness. Ideally, this debt is acquired as part of a long-term program, but in many cases when a currency is under pressure local currency debt can be increased fairly quickly at costs that are well below those of hedging.

A third alternative, one that I purposefully left for last as it has been treated so extensively elsewhere, is that the financial officer may try to hedge his exposure by buying or selling the threatened currency in the forward market: Buying if he has a short position and expects a revaluation; selling if he has a long position and expects a devaluation. Contrary to what some people who are not frequently

involved in this type of activity often assume, the expense of a hedge is yet another cost that cannot be calculated precisely inasmuch as it depends on the spot rate at the time of maturity. For example, assume that a company has a positive exposure in sterling and expecting a devaluation decides to hedge by selling sterling 3-months forward. The cost of the hedge can be estimated by dividing the 3-month premium or discount by the most likely spot rate at the time of maturity, annualizing the result and converting it into a percentage cost. This estimated result can then be compared to the estimated cost of doing nothing and the estimated cost of debt. Many companies realizing the danger of relying on single estimates, calculate a range of possible costs using the most advantageous, the most disadvantageous and the most likely spot rates that they feel might exist when the contract matures. This indicates a maximum, a minimum and a most likely cost, all of which can be useful in evaluating the desirability of using hedging for protection.

Unfortunately, even these estimated costs can be very misleading until taxes are taken into consideration because, at least in the United States, a gain on a forward contract is generally taxable as income while in many circumstances a loss due to a devaluation or revaluation might not be deductable for tax purposes. Thus, a corporation in the 50% tax bracket may have to hedge twice the exposure to be fully covered on an after-tax basis, and an estimated hedging cost of 4% becomes 8% if the financial officer must buy or sell twice his exposure to be fully protected. And it is this 8% that has to be compared to the after-tax cost of debt. However, the tax consequences of hedging or even the tax consequences of debt are too complex to discuss in any detail at this time, and the subject is introduced only to underscore its importance.

At this point there is a strong temptation to make a few comments about how businessmen and their staffs estimate the probability and amounts of future currency changes and to present some thoughts about the outlook for specific currencies. However, the remaining observations will concern only the general monetary outlook, except for a few comments about the U.S. dollar. The main conclusion at this point is that even in today's highly uncertain currency environment there are objectives, strategies, quantifiable options and possibilities for implementation that make it possible for business management to cover and perhaps even benefit by foreign exchange exposure.

THE MONETARY AND EXCHANGE RATE OUTLOOK

Recent statements about the outlook for the U.S. dollar range from very bullish (those who think that the U.S. may have over-devalued) to moderately bearish (those who feel that the U.S. price-performance continues to be inadequate and that monetary outflows not affected by changes in the relative value of currencies, such as interest payments on foreign debts, will continue to overshadow anticipated improvement in sectors that are responsive to varying degrees to the recent currency realignments). Without going into detail, it can be noted that a common, short-term scenerio, and the one to which I subscribe at this time, seems to be that in the absence of any major regulatory or policy changes, the outlook for the dollar in the months ahead is for further significant deterioration, moderated in some currencies by the efforts of other nations to keep the relative value of their currencies from strengthening too much.

There is also a wide range of opinion concerning the longer-term outlook. One group is awaiting the favorable results of recent devaluations, expecting that the favorable effects will be fundamental and long lasting. At the same time, there is a growing opinion that the longer-term outlook for the dollar may be not bright unless some basic changes materially alter domestic economic behavior as well as some of the United States' international relations. It is argued that these changes do not presently appear likely since benign neglect in international financial matters is, for better or worse, somewhat of a reality in a nation where gross exports plus imports equal less than 10% of a Gross National Product of more than 1.2 trillion dollars, and where a 30 billion dollar balance of payments deficit is less than 3% of GNP. Thus, a number of analysts argue that the dollar may have to experience a relatively modest but persistent annual deterioration for many years to come to remain competitively aligned in international markets.

Whether your view is that the U.S. dollar will firm for many years in a lagged response to recent devaluations or deteriorate persistently, it is clear that the nations of the world would be well advised to create a monetary system sufficiently flexible to permit gradual currency shifts, interspersed with the inevitable flurries that accompany developments such as military threats, important policy changes and cyclical movements in key domestic economies.

Additionally, a large number of unresolved and potentially disruptive issues further underscore the need for the greatest possible flexibility in the international monetary structure. There is, for example, the accumulation of dollars in the Middle East, the dollar overhang in the coffers of central banks, and the estimated 275 billion dollars in liquid funds held by corporations and private banks around the world. These and other monies are presently available in unprecedented amounts, ready to shift rapidly to new havens when danger signs occur. There are also problems such as the need to develop a new international reserve currency, the potential strains inherent in the so-called "floating snake", the question of frozen gold reserves, reoccurring conflicts between domestic and international objectives, the imposition and removal of exchange and capital controls, and so forth.

To benefit from some perspective on where these observations might lead, perhaps we can turn to a speech that Arthur Burns made in Montreal on May 12th of last year. After observing that the floating rates between August and December of 1971 were generally unsatisfactory and their behavior "did not conform to the model usually sketched in academic writings", Mr. Burns went on to note that "fortunately" this dangerous trend of floating rates was halted by the Smithsonian Agreement which "was worked out with care by practical and well-informed men." With advantage of hindsight, it is clear that one of the problems with floating rates from August to December of 1971 was the widespread knowledge that they would some day be repegged. Rather than permitting movements in response to market forces, most nations intervened in the markets to hold their currencies at artificially low levels so as not to lose a competitive edge in the subsequent bargaining process.

We also know what happened to the Smithsonian Agreement that Mr. Burns praised so highly. Within one year of the Montreal speech, the world exchange markets experienced a series of the most disruptive upheavals in recent history. Sterling, which had a parity of $2.40 prior to the Smithsonian agreement and which had been reset at $2.60 in December 1971, floated right back to the $2.40 level in less than six months. The Swiss franc and lire broke through their Smithsonian bands shortly thereafter; the U.S. dollar devalued for the second time within 14 months; official currency markets were forced to close for an extended period; and only with the re-introduction of widespread floating did currency trading resume the type of orderly activity so essential to the continued expansion of world trade.

These observations are not intended to cast aspersions on the conscientious efforts of central bankers throughout the world. Rather, events of the past year have revealed that the availability of data and the state of arts do not permit even the most well-informed and best-intentioned men to develop a workable long-term plan, if that plan significantly blocks market forces from determining currency levels. In today's context, all such attempts are doomed to either collapse or produce destabliizing pressures elsewhere: for example in disruptive leads and lags, trade and capital controls and other areas. Even rates that are permitted to adjust in accordance with selected indicators are predestined to be inequitable (at best) and unworkable (at worst) as nations learn to manipulate the indicators. For example, the recent Japanese recycling of reserves indicated that there can be "dirty reserve levels" as well as "dirty floats". Certainly balance of trade and balance of payments numbers and even price indexes can be altered by, for example, changing sampling techniques or altering the items included.

In conclusion, we have seen that there are many techniques by which businessmen throughout the world are successfully adjusting to every conceivable method of exchange rate movement, including widespread floating. In the past year, we have experienced how arbitrarily fixed parity relationships have produced near chaos that continued until being replaced by increased reliance on market forces. One might conclude, therefore, that the greatest uncertainty in today's monetary outlook and perhaps the greatest danger to international exchange rate stability is that the finance ministers and central bankers will make progress in their forthcoming meetings . . . progress, that is, in implementing a new system of rigidities that will probably, sooner or later, result in still more controls, greater incentives for nationalistic manipulation and an increased propensity for the type of disruptive currency movements that so dramatically marked the last quarter century, but which have been noticeably absent since mid-March.

Clearly the international monetary outlook is complex and uncertain, especially with some nations trying to permit greater flexibility while simultaneously striving for a single currency. But one thing is clear: with each passing year

businessmen throughout the world are becoming increasingly aware of the unnecessary cost of operating under the destabilizing influences inherent in fixed rate systems and are increasing utilizing techniques for functioning successfully when exchange rates are determined by the more predictable, incremental influences of market forces. It is important, therefore, that businessmen not give lip service to the desirability of fixed exchange rates while simultaneously devoting their energies almost entirely to the successful implementation of methods for operating under conditions of increased flexibility. Only when central bankers become thoroughly aware that the business community can live with and indeed prefers increased flexibility with minimum control can we avoid a return to the destabilizing rigidities of the past.

Mr. TECK. Perhaps the gist of that entire speech can be suggested with one observation. Recently, I had occasion to visit two large multinational corporations with headquarters in New York City. They produce virtually identical products and their worldwide activities are very similar. I asked the treasurer of one of the corporations what he is doing to get adequate protection for his company during this period of floating rates. He immediately began listing some of his activities in this area, until I finally asked him to stop.

Subsequently, I asked the same question of the senior financial officer in the other corporation. He immediately began reciting all of the problems that he was having with floating rates and indicating that he couldn't possibly live with such a system if it lasted much longer.

What this suggests to me is that there are some corporations that have not yet learned how to live with floating rates. But competitive pressure will soon force them to learn; because it will not be too long before the financial officer in the second corporation is replaced by someone more capable. Committees such as this will undoubtedly hear complaints from those corporations that have not adjusted quickly to the new environment. But my experience indictes that most corporate treasurers are rapidly discovering and implementing methods to operate safely and profitably under floating rates, and I am sure that such knowledge will continue to proliferate to the rest of the community.

Mr. Hawes indicated that implementing protection strategies under a system of floating rates could involve substantial costs. When one looks at individual corporations and very specific situations, this could be correct. But when one considers the entire community, I am not so sure that it is. As an example, assume that sterling is at a discount, and a U.S. exporter ships to the United Kingdom and invoices in dollars. The U.K. importer requires more sterling if he buys dollars in the forward market to protect himself at a predetermined price. Therefore, the U.K. importer has a higher cost because of his desire to be fully protected against possible currency fluctuations. The U.S. exporter may either lose a customer or have to absorb part of that cost. On the other hand, under the same conditions, with sterling selling at a discount in the forward market, the U.S. importer who must pay sterling invoices can fully protect himself and reduce his costs by using less dollars to purchase the required sterling in the forward market. He can pass his saving on to his customers or increase his profits. Therefore, regardless of whether forwards are at a premium or discount some people absorb costs while others profit.

The only reason that people look for other means of protection is because the effects of forward premiums on discounts fall unequally on different parts of the community. But looking at a community as a

whole, international payments can be fully hedged at all times, with one person's costs being another person's savings.

While we are on this subject, Mr. Leclerc mentioned the large premiums and discounts under the floating rates. The evidence indicates that such premiums and discounts, under even today's highly uncertain conditions, are considerably smaller than they were during many periods under the Bretton Woods system. The data suggest that large premiums or discounts that cannot be explained by interest rate differentials occur when there is a difference between an artificially maintained exchange rate and market expectations. Such a situation is less likely to occur under a float than a fixed parity system.

Turning to some suggestions for central bank guidelines. Today's foreign exchange environment is different from all preceding periods in that there has never been such large amounts of liquid capital, mostly U.S. dollars, held throughout the world; never before has there been such sensitivity to factors that appear likely to change the value of these assets, and never before has there been more rapid communication or faster methods for transferring these funds from one asset to another.

As we all know, when a consensus develops about the strength or weakness of a currency, the equivalent of billions of dollars can shift into or out of a particular currency or asset in a matter of hours, with all of the accompanying dislocations and associated problems. The Bretton Woods arrangement of fixed bands maintained by central bank intervention has proved to be inadequate to this new environment. Floating rates on the other hand, have been much more capable of absorbing huge currency shifts and are therefore probably better suited to present needs than any other system presently being discussed.

After floating rates were tried from August to December of 1971, it was widely noted that they did not work well at that time. With the advantage of hindsight, it is clear that one of the problems of that period was the widespread knowledge that the floating rates would someday be repegged. Rather than permitting movements in response to market forces most nations intervened to hold their currency at artificially low levels so as to retain a competitive edge in the subsequent bargaining process. The only fair test of floating rates occurs when the market expects such a system to continue indefinitely.

In today's environment it seems clear that central banks should play a minimum role in the foreign exchange markets until it is apparent—and it is not apparent at present—that their intervention can produce positive results from the standpoint of improving world trade and investment. At present, therefore, I propose that central bank intervention should be confined to smoothing day-to-day fluctuations. These institutions should avoid any intervention that is inconsistent with foreign exchange levels being determined by market forces. The most appropriate guideline, in my opinion, would be for central banks to maintain net zero balances in their foreign exchange activities over a reasonably short period such as 3 to 6 months. They should be required to report their activities each month for monitoring by an appropriate international agency.

As noted in the accompanying paper, events of the past year have revealed that the availability of data and the state of the arts do not

permit even the most well-informed and best-intentioned men to develop a workable long-term plan for regulating movements in foreign exchange if that plan significantly blocks market forces from determining currency levels. Even rates that are permitted to adjust in accordance with selected indicators are predestined to be inequitable—at best and unworkable—at worst as nations learn to manipulate the indicators. For example, the recent recycling of reserves in certain countries indicates that there can be managed reserve levels as well as managed floats. Certainly balance of trade and balance of payment numbers and even price indexes can be altered by, for example, revising sampling techniques or changing the items included.

Any central bank intervention according to an established formula is destined to be self-defeating as the market learns to discount such intervention in advance. By removing central banks from the market, one removes the points of reference that enable traders and businessmen to establish profitable positions with minimum risk. When the market is completely free to move in either direction, there is sufficient risk to discourage such positions.

However, there should be no rush to establish even those guidelines which will limit central bank intervention to smoothing operations until it is clear that such regulations can be enforced, and more importantly, until steps have been taken to dismantle the large and increasing number of trade and capital controls that have recently been used in place of direct intervention to influence currency levels. Governments should not permit prohibitions against direct central bank intervention in the foreign exchange markets to result in a proliferation of controls in other areas.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Teck follows:]

Prepared Statement of Alan Teck

Events since mid-March have indicated that the recently created system of foreign currencies floating against the Dollar is working surprisingly well. This arrangement appears better suited to the current environment than any of the previous systems and probably better than any of the alternatives presently under discussion. Banks and other types of businesses appear to be adjusting quickly and easily to the present foreign exchange arrangements, and recent experience suggests that any further changes that might be required by a prolonged float will probably be relatively minor. One of my main conclusions is that the present system of currencies floating against the Dollar should be continued indefinitely, with only minor modifications designed to further reduce central bank intervention. At the same time, governments should not permit the significantly reduced central bank intervention in the foreign exchange markets to result in a proliferation of controls in other areas. Over the long run additional efforts should be made to dismantle other government impediments to freer trade and capital movements.

These remarks briefly discuss some aspects of how the recent shift to floating rates has affected the activities of commercial banks and other types of corporations, with particular reference to the continued expansion of international trade. One conclusion is that the best guidelines for central bank involvement in the foreign exchange markets may well be those which permit intervention only to smooth day-to-day currency movements while prohibiting activities that would otherwise influence or distort the currency levels determined by market forces.

BANKING ACTIVITY SINCE THE FLOAT

A few observations can be made about the effect that the present float is having on the activities of commercial banks in the areas of financing international trade, foreign exchange trade, investing, lending and borrowing.

From the worldwide viewpoint there is absolutely no reason to believe that floating exchange rates will, or should, reduce the volume of world trade. However, as Fritz Machlup points out in a recent article in *Euromoney*, it is easy to understand how such an idea got started. The belief was created and reinforced by the experience and complaints of individual exporters. But when import and exports are considered together there is no apparent adverse relationship between floating rates and the overall volume of international trade. As the value of a foreign currency declines relative to the Dollar, the United States will tend to import more and export less. On the other hand, when the value of a foreign currency improves relative to the Dollar, the United States will tend to import less and export more. Thus, while the effects may vary as relative exchange rates change, the impact on overall activity may remain relatively constant as exports and imports become alternatively attractive. Indeed, during the past decade, a period filled with large and frequent changes in the relative value of currencies, the volume of international trade has more than tripled, with a significant gain every year. Advances in 1971 and 1972 were 12% and 17%, respectively, with substantial increases in real terms as well. And to the extent that it is appropriate to draw inferences from Chemical Bank's financing data, international trade does not appear to have suffered since the inception of the floating Dollar this past March.

A good part of international trade is financed with letters of credit, bankers' acceptances and direct payments handled by foreign collection departments of commercial banks. It is interesting to note that Chemical Bank has experienced no significant changes since March of this year in either the number or volume of these types of transactions, other than modest increases that can be accounted for by the Bank's normal growth pattern. In fact, when reviewing the number of transactions handled in these departments each month from January, 1972, through May of this year, one is impressed by how stable the growth trends have been both before and after this past March. To the extent that the experience of Chemical Bank is typical of other major commercial banks, it appears that the often expressed notion that floating rates would sharply curtail world trade is not materializing, and presently there is no indication that such a reduction is likely to develop.

Within the context of the continued expansion in the financing of international trade, at least one trend that has developed in recent months may be worth mentioning: the growing tendency to denominate invoices in currencies other than U.S. Dollars, primarily Deutsche Marks, Swiss Francs and Yen. As this trend has developed one would expect to see an increase in the Bank's foreign exchange activity as U.S. importers buy foreign currencies in both spot and forward markets to pay invoices and as U.S. exporters sell the foreign currencies that they receive to obtain Dollars. And such a trend has been observed in our foreign exchange trading activity since March of this year.

In the past three months, there has been a significant increase in the number and volume of foreign exchange transactions handled by our traders in New York. The number of transactions has risen 12% over those handled in the same period in 1972, and the amounts have also risen at about the same rate. However, when one studies these transactions, it is interesting to note that the entire increase has occurred in categories in which foreign currencies are being purchased or sold in connection with invoices denominated in currencies other than Dollars, not, as some have suggested, in areas that represent banks and corporations taking larger or more frequent positions for either protection or speculation.

Having noted the sharp rise in the number of foreign exchange transactions handled in our New York office, let me add one comment about a remark heard with increasing frequency: namely, that bankers welcome floating rates as they have resulted in significantly wider spreads between bid and offer quotations, a substantial increase in trading volume and therefore larger trading profits. The relationship between bid and offer quotations and trading profitability is an often misunderstood concept. Foreign exchange traders deal in three markets simultaneously: they trade with corporate customers, other private banks and central banks. One set of spreads between bid and offer quotations exists in the dealings with corporate customers. A recent spread in Sterling, for example, might have been 2.5730–42, with Chemical Bank buying Sterling at 2.5730 and selling at 2.5742. However, when Sterling is experiencing upward pressure, most customers are buyers of Sterling at 2.5742 and very few, if any, are sellers. To obtain the necessary Sterling, the traders must then enter the interbank market. Other banks, realizing that Sterling is experiencing upward pressure, will charge a maximum price, which might be as high as 2.5740, 2.5741 or even higher if it is

felt that upward pressure will continue. Thus, the relevant spread from the standpoint of trading profitability is the difference between 2.5742, the actual sale price, and the actual purchase price in the interbank market. In other words, the appropriate spread for calculating profit or loss is the difference between the sale price in the corporate market and the sale price in the interbank market, and vice versa when a currency is under downward pressure. Because of this, one would expect to see no significant difference in profitability when spreads in the corporate market are narrow or wide. Unfortunately, it is virtually impossible to separate profits from spreads between bid and offer quotations from profits associated with the number of transactions or gains and losses from positions taken in various currencies. It is interesting to note, however, that since the introduction of floating rates, the Bank's overall trading profits seem to confirm the analysis that wider spreads do not result in increased profitability.

A second point can be made with respect to the spread between bid and offer quotations in the corporate and interbank markets. It is by no means clear that spreads have widened as a result of the floating system instituted in March. During the few weeks immediately after the markets reopened in late March such spreads were relatively narrow as the performance of the U.S. Dollar suggested, at least temporarily, that an equilibrium condition may have been achieved. Then about mid-May, as the U.S. Dollar began to decline and uncertainty increased, spreads widened. This followed a typical pattern observed throughout the entire post-1945 period: spreads tend to widen during periods of uncertainty and narrow during times of relative calm. Thus, widening and narrowing of spreads appears to be related to changes in the degree of uncertainty, with no apparent relationship between floating or non-floating systems. Indeed, the present spreads are significantly narrower than those that existed during many periods of uncertainty under the Bretton Woods system.

Thirdly, under the fixed rate system there was an incentive to acquire a position in a strong currency when it was at its ceiling in anticipation of a change in parity. Under a floating system, however, there is a greater reluctance to acquire such positions even when the general direction of a currency seems fairly certain. The greater risk of two-way movements increases the possibility that a trader will experience unacceptable losses trying to maintain such a position while also actively trading. Early evidence suggesting that the floating rates may have reduced the incentive to take and maintain such currency positions is generally considered a favorable development.

Three other major areas of bank activity—investing, lending and borrowing—appear to have been virtually unchanged by the advent of floating rates. Certainly no difficulties or unusual situations have developed which might impede banking activity or the further growth of international trade and investment.

Attention will now be turned to how corporations have acted under the floating system that has been in effect since March.

CORPORATION ACTIVITY SINCE THE FLOAT

Part of my responsibilities as head of Chemical Bank's Foreign Exchange Advisory Service is to consult almost daily with U.S. and foreign corporations about the management of their foreign exchange exposure. In the past month alone I have discussed this subject with numerous multinational corporations in the United States and Europe. The overriding impression gained from these discussions is while some businessmen feel understandably uneasy as they enter the new environment of floating rates, very few have done anything differently as a result of the float in the past three months. In almost all cases, however, there has been a continuation of the greatly increased sensitivity that has developed in recent years to problems associated with periods of uncertainty in the foreign exchange markets. In addition, there has been a continuing effort to refine techniques for developing protection against losses associated with such an environment.

On May 15th of this year, I was a speaker at the first meeting of the International Federation of the Associations of Business Economists, an umbrella group formed to increase the association and communication among professional business economists throughout the world. My paper, *Managing Foreign Exchange Exposure in an Uncertain Environment*, describes the wide range of possibilities for exchange rate movements that have existed during the past quarter century and discusses many of the methods that the businessmen have used to adapt to this highly uncertain environment. My recent contacts with corporation finance officers have indicated that most of the accounting, operational and hedging strategies have continued to be refined and are now used with increased vigor under the present

floating system. It is my guess that there will be even greater sensitivity to, and refinement of, these techniques as rates continue to float. With your permission, I would like to have the presentation written for the International Federation of Business Economists included in the record of these hearings.

Perhaps it is relevant to make one additional observation with respect to the outlook for corporate participation in international trade and foreign exchange markets. As long as there are active forward markets, full exchange rate protection is available to both exporters and importers. And forward markets under the floating rate system have demonstrated the same depth, breadth and resiliency as under fixed rate systems.

A typical observation when the preceding point is made is that constant hedging involves a cost that must be either passed on to consumers or absorbed in lower profit margins. While this may be true in specific cases at particular times, it is not valid as a general observation. The forward market for a particular currency is usually traded at either a premium or discount. If, for example, a U.S. exporter sells goods to the United Kingdom on 90-day terms, and Sterling is at a discount, the anticipated Sterling can be sold in the three-month forward market so that when payment is received the exchange for Dollars can be at a predetermined price. Because forward Sterling is at discount, the U.S. exporter will receive a lower Dollar equivalent than the present spot rate. However, a U.S. importer buying goods from the United Kingdom and being invoiced in Sterling will benefit from the fact that he can obtain the necessary Sterling at a lower Dollar equivalent. These savings can be passed on to customers. Taking the global approach, exporters and importers in the United Kingdom and other countries will experience gains and losses in exactly the same manner. Thus, regardless of whether the forward markets for foreign exchange are at premiums, discounts or flat, it is conceivable that there might be no significant worldwide cost associated with all businesses maintaining constantly hedged positions in foreign exchange. The reason that businesses search for other means of protection is that the costs of fully-hedged positions fall unevenly on different businesses at different times and there is a constant effort to eliminate the effects of such discrepancies.

It can be noted that during the recent period of floating rates forward markets have been active with approximately twenty major currencies displaying ample trading volume and activity for periods of up to one year and most cases even longer. Thus, under floating rates, full protection is available when required. Banks can also achieve full protection by moving into "squared" or balanced positions whenever uncertainty and the associated risks reach unacceptable levels.

SUGGESTED CENTRAL BANK GUIDELINES

Today's foreign exchange environment is different from all preceding periods in that there has never before been such large amounts of liquid capital, mostly U.S. Dollars, held throughout the world; never before has there been such sensitivity to the factors that appear likely to change the value of these assets; and never before has there been more rapid communication or faster methods for transferring these funds from one asset to another. As we all know, when a consensus develops about the strength or weakness of a currency, the equivalent of billions of Dollars can shift into or out of a particular currency or asset in a matter of hours, with all of the accompanying dislocations and associated problems. The Bretton Woods arrangement of fixed bands maintained by central bank intervention has proved to be inadequate to this new environment. Floating rates, on the other hand, have proved much more capable of absorbing huge currrency shifts and are therefore probably better suited to present needs than any other system previously used or under current discussion.

After floating rates were tried from August to December of 1971, it was widely noted that they did not work well at that time. With the advantage of hindsight, it is clear that one of the problems of that period was the wide-spread knowledge that the floating rates would someday be repegged. Rather than permitting movements in response to market forces most nations intervened to hold their currency at artificially low levels so as to retain a competitive edge in the subsequent bargaining process. The only fair test of floating rates occurs when the market expects such a system to continue indefinitely.

In today's environment it seems clear that central banks should play a minimum role in the foreign exchange markets until it is apparent—and it is not apparent at present—that their intervention can produce positive results from the standpoint of improving world trade and investment. At present, therefore, I propose that central bank intervention should be confined to smoothing day-to-day

fluctuations. These institutions should avoid any intervention that is inconsistent with foreign exchange levels being determined by market forces. The most appropriate guideline, in my opinion, would be for central banks to maintain net zero balance in their foreign exchange activities over a reasonably short period such as three to six months. They should be required to report their activities each month for monitoring by an appropriate internatioal agency.

As noted in the accompanying paper, events of the past year have revealed that the availability of data and the state of the arts do not permit even the most well-informed and best-intentioned men to develop a workable long-term plan for regulating movements in foreign exchange, if that plan significantly blocks market forces from determining currency levels. Even rates that are permitted to adjust in accordance with selected indicators are predestined to be inequitable (at best) and unworkable (at worst) as nations learn to manipulate the indicators. For example, the recent recycling of reserves in certain countries indicates that there can be managed reserve levels as well as managed floats. Certainly balance of trade and balance of payment numbers and even price indexes can be altered by, for example, revising sampling techniques or changing the items included.

Any central bank intervention according to an established formula is destined to be self-defeating as the market learns to discount such intervention in advance. By removing central banks from the market, one removes the points of reference that enable traders and businessmen to establish profitable positions with minimum risk. When the market is completely free to move in either direction, there is sufficient risk to discourage such positions.

However, there should be no rush to establish even those guidelines which will limit central bank intervention to smoothing operations until it is clear that such regulations can be enforced, and more importantly, until steps have been taken to dismantle the large and increasing number of trade and capital controls that have recently been used in place of direct intervention to influence currency levels. Governments should not permit prohibitions against direct central bank intervention in the foreign exchange markets to result in a proliferation of controls in other areas.

Chairman REUSS. Thank you, Mr. Teck

Before calling on Senator Percy, I would ask such of you as wish to respond to Senator Javits' two questions, which, capsulized, were:

1. To what extent did multinational corporations participate in recent currency speculation; and

2. Should a monetary reform agreement be before, after, or at the same time as a trade agreement?

You may either respond now or when you review your testimony. I know Senator Javits would be most happy to have you add anything then. But if one or more of you have anything to say now in response to those questions, let's hear from you now.

Mr. Abboud.

Mr. ABBOUD. Mr. Chairman, I think these are very important questions, and current questions. And I would like to answer by citing the factors which the multinational corporation faces in the marketplace.

If a multinational corporation has an investment in Germany, if it has a capital investment in marks, for example, in a subsidiary of that area, and then if the mark appreciates relative to the dollar, the normal accounting rules require the company to take the appreciation in the value of that capital investment into its income statement, and to reflect it on its balance sheet. If there is a subsequent turn around and the dollar strengthens as against the mark, again periodically, whether quarterly or annually, there has to be a revaluation. And if there is a reduction in the value of that asset, that then has to flow through the income statement, and may interfere—it may be significant to the larger multinational corporation—it may interfere with the

earnings for that year, and it may interfere with its price/earnings multiple in the capital market. As a result, the corporation, once it has taken profit into the income statement, is very reluctant to have that profit disappear by having a reversal of currency parities. And so it then comes to its bank and it says, I have this profit locked in, it is now at a new value, we have just revalued it, and I would like to hedge it. When they do that, the foward markets may be very thin. And the bank would then have to hedge that on a short-term basis, or maybe in the spot market. And this means that the long dollar balances or the long balances of whatever happens to be the strong currency at that particular time would increase both from the standpoint of the bank and the standpoint of the multinational corporation. So I would suggest that because there is a floating system and there are no limits, no corporate management can really afford to take the risk of having wide oscillation, over the short term, of the relative parities of the currency, because any change must be duly reflected in the quarterly income statement. Because of that, this stimulates a great deal of activity, and the bulk of that activity is in the spot position, and therefore that creates further instability. So I would say, you have had a lot of activity; it was not currency speculation, it was trying to protect the validity of the income statement.

On the second question, it seems to me that before you can have a meaningful trade negotiation you have to have an understanding as to what the monetary system is likely to be for the foreseeable future. I gave one example and said, well, if you give a 15.2 percent reduction in tariffs on widgets, that implies that the foreign country that is going to sell widgets in the United States is going to develop X percent of the market in widgets, and that is going to have an impact on our own domestic producers. This calculation permits us to grant that type of a concession. If, the next day, the relative parities between the currencies change, and instead of having 40 percent of the market in the United States, foreigners end up with 82 percent of the market, that is going to have a direct impact on our manufacturers and our work force in this country, and we are not going to like it. And the agreement that we made yesterday is going to come apart. So I would think you have to have some sort of a fabric if you are going to play a game such as, "I will reduce 15 percent if you will reduce 25 percent." If you are talking about a system where there were no tariffs, no barriers, no controls, then that is a different story. But that is not the system that exists at the moment.

Thank you.

Chairman Reuss. Thank you.

Mr. Teck.

Mr. Teck. I would like to comment on Mr. Abboud's first observation, because we have gathered some data at Chemical Bank that may be helpful to the discussion. As I mentioned before, since the recent float began the number of transactions handled by our foreign exchange traders has increased sharply. However, we have categorized these transactions and noted that all of the increase has been in items related to international trade: Transactions that have trade documents to support them. The number of all other types of transactions has been relatively stable since the float began. Moreover, as you know, banks deal primarily in one market with corporate cus-

tomers, and in another with other banks. We have also noted that our interbank activity increased significantly since the float started. This leaves the only other category, corporate activity, actually declining in terms of the number of transactions since the float. To the extent that these data are representative, they suggest that the float is tending to discourage corporations from making positions above and beyond those required by their normal trading needs.

Mr. Abboud also made a point which I think is very consistent with an observation that I previously made. It is germane. I think, to refer to it in further detail at this time.

I mentioned that some corporations are learning to live with the floating exchange rates quickly and without significant cost while other corporations have yet to adopt the same techniques. It is true, as Mr. Abboud points out, that some companies, when they have large foreign exchange windfalls, take them into their income statement, and then if there is subsequently an adverse rate movement their income statement has to be adjusted downward. They may not want the downward adjustment, so they may pay a penalty (of course they may also realize a gain) by hedging their exposure in the forward market. However, other companies have learned to avoid such operations by smoothing out the effects of exchange fluctuations on their income statements by the judicious use of reserves. This is just one small example of how some companies are operating more effectively than others. The knowledge that most corporations are starting to develop is soon going to proliferate throughout the entire community There is no need to absorb ongoing hedging costs, there are other ways to accomplish the same ends.

Chairman Reuss. Mr. Leclerc.

Mr. Leclerc. In response to the first question regarding the operations of multinational corporations, it has been our experience since the early part of this year that there has been no notable increase in the volume of activity by multinational corporations.

And backing up Mr. Teck's statement, we have also noted a considerable increase in the total volume of foreign exchange, which I think is due primarily to the shifting of exchange markets from other centers to the United States, because the United States is no longer the sole vehicle currency being used, and because of the uncertainty over the U.S. dollars, there is a tendency for goods to be invoiced to a far greater degree in other currencies, which, of course, means that the exchange operations are being concluded on this side of the ocean rather than on the other side. And I do not believe that there has been any significant increase in multinational corporations operations in the exchange field which would tend to indicate any kind of speculation on their part.

I think one misconception that I have noted in travels abroad recently is that multinational corporations are frequently accused of such speculation. It is ironic that the corporate treasurer of some multinational corporations that might be headquartered in some European country, if he was that liquid that he could move such massive amounts of money around at will, I am sure he wouldn't have his job for very long. I think if we wanted to look for where the actual movements, massive movements of speculative funds are coming from, I think we would do well to look at other sources of supply who are the very sources who are working in the market today

on the floating rate system in the absence of any significant intervention by central banks in exchange operations.

Chairman REUSS. To wit?

Mr. LECLERC. I think, with the possible exception of the reported intervention of the Bank of England last week, and the Bank of France last Friday, there has not been any significant intervention certainly by the Federal Reserve bank on this side of the Atlantic, and with just relatively little intervention in Europe. These selfsame factors who have not been publicly pinpointed are substituting for central banks in moving exchange rates. Let us look at the move in the deutsche mark rate, for instance, since the February 12 devaluation of the dollar. Following the devaluation of the dollar, the deutsche mark was trading at a very comfortable 2.83 to the dollar for several weeks. Since that time it is now reduced, or the value of the dollar has gone down, to a level of 2.55, which is almost a 10 percent decrease in the value of the dollar versus the German mark. Now, certainly this is an awful lot more significant than any previous adjustments we have had in parities under the Bretton Woods system. And I think that the frequency of these kinds of movement can easily be brought about by these massive forces of speculation who I do not believe are multinational corporations in moving these exchange rates by significant amounts.

Chairman REUSS. My question was, you say they aren't the multinationals; they aren't the central banks. Who are they?

Mr. LECLERC. We have often referred to the gnomes, whether they be in Zurich or whether they be in New York, or whether they be in Frankfurt, or wherever they may be. I think the gnomes are the ones that have to be looked at. And the gnomes aren't all necessarily located on the main financial drag of any major financial center. I think you have an awful lot of gnomes in corporations also, besides being in the banks which do permit more liberalized types of position taking. I think you have had some rather massive movements in the past several weeks that we have seen come over the exchange market, and reported positions being taken by certain operators which are of astronomical size. They are actually of central bank size. So these people are basically replacing central bank intervention, and it is not intervention with thei ntent of ironing out the inequities of the market or bringing into balance the forces of supply and demand, but rather to move exchange rates to levels that would generate rather quick windfall profits to those who are in a position to operate to this large degree.

Chairman REUSS. I think this is interesting enough so that I would like to pursue it, unless Senator Percy wants to leave it.

Senator PERCY. I would like to question for a few moments.

Chairman REUSS. I am very interested in this. But I think it would be fairer to come back to it.

So why don't I call on Senator Percy.

Senator PERCY. I appreciate that very much. Unfortunately we have a bill on the floor that is going to require continuing votes. Please break in at any time.

I would first like to make this observation, Mr. Chairman. These are exceptionally good hearings, especially when I think back to my work at the University of Chicago and the school of economics. This is one reason I would pay to keep this job. It certainly furthers my education in understanding some of these very complex problems.

Chairman REUSS. Be sure to hear Professor Friedman this afternoon.

Senator PERCY. I would certainly like to do that. I would point out that Prof. Paul Douglas is also a professor of economics in the University of Chicago, so there is more than one point of view there.

But this is an exceptionally fine panel, and I am delighted to have financial institutions with headquarters in Chicago represented.

I would like to pursue a few points. My first point is multinational corporations. I ask the question because multinationals are under tremendous attack now. The Foreign Relations Committee on which I serve has formed a separate subcommittee for a 3-year intensive study of the operations of multinationals around the world. I serve on that subcommittee.

Thinking back some years ago when I headed a multinational corporation, I called on both the Chicago financial institutions for counsel and advice. What do we do as a company when we have large royalty income from the sterling area—it was better than 70 percent of our foreign income—and yet we faced the possibility of devaluation?

The advice we were given was that we should hedge. We should buy futures. We should protect ourselves to the extent of our expected earnings, because we had already counted and were making capital investment based on that cash flow coming in. And that is just exactly what we did.

For the most part multinationals, in your judgment, are not speculating to make money in those fields, but are taking necessary conservative steps to protect expected income for which they have budgeted. If they were precipitously dealt with and overnight had an action taken that would wipe that expected income out, would it not seriously impair their planning and procedures?

Mr. PRUD'HOMME. I wonder if I could respond to that.

I think this question is not so different from Senator Javits' first question, in which I believe he used the phrase, "normal business," and was trying to see if there was much distinction between a corporation's normal business and what it does in the foreign exchange market.

Well, I assume that by definition "normal business" is maximizing profits and limiting losses to the extent possible. We have mentioned here today a number of barriers or difficulties having to do with accounting principles, having to do with controls imposed by governments abroad, having to do with the costs of forward hedging operations. And clearly all of these kinds of things have a direct effect on the hedging strategies of the corporations. They are not altogether free agents. There are boundaries within which they have to work.

But they are still trying to maximize their profits or protect their earnings, however you wish to state it.

Now, I don't see myself that protecting one's earnings, and therefore one's shareholders—and that means the public at large in many cases—by taking out insurance policies, is in any sense speculative action.

Secondly, these large corporations in their domestic operations have important short- or long- term investment portfolios. The short-term portfolios are largely excess cash that has been held aside temporarily

and the longer term portfolios generally relate to pension funds and things of that sort for investment in the securities markets.

I am not aware that anybody is critical of these corporations because they set up maturity ladders to maximize the yield on their short term investment portfolios based on a judgment as to where interest rates are going; nor am I aware that such corporations are criticized for changing the diversification in their investment portfolios, switching from one security to another, trying to maximize their profits, or if you wish, to increase their earnings or the benefits. And I am a little concerned that when we start talking about the international area, where corporations are doing very much the same kind of things—they are adjusting maturity ladders, they are borrowing in one currency or another, they are hedging forward, particularly export transactions, or whatever it may be—I am a little concerned that we somehow apply a different set of rules or try to judge those operations differently than we do for the normal business operations that these corporations engage in.

Senator PERCY. I wish to be a little more blunt about it so that there is no chance of evasion. I don't intend my questions, even though I represented a multinational and serve on a bank board, to be "patsy" questions. Can you give us specific instances—and I must represent tens of thousands of companies—where on any sort of a large scale, financial officers were dealing speculatively. Where they were trying to show for their own bonus purposes or their own operations a big speculative profit. Can you cite a case that in your judgment went beyond the normal business operations of an industrial corporation, of a case where the financial officer manipulated the money markets in order to speculate and make a quick profit. Can you give us such a specific case? You don't have to name names, but give us the dimentions, the size of it, and the circumstances.

Mr. TECK. I can answer you in one word: "No." It may be that the reason people are having difficulty finding a scapegoat, if you will, for the so-called massive monetary flows, is that in one sense there may not be massive monetary flows. Let me explain. And I am going to overgeneralize to make a point.

A recent study by the U.S. Tariff Commission estimated that approximately $267 billion was held in foreign liquid funds by multinational corporations and banks. That study was done some time ago, so let's round the amount to $300 billion. That means that if there is a 1-percent movement, $3 billion will flow from one asset to another. Even in today's market $3 billion represents a massive flow in absolute terms. Why can a 1-percent shift move the markets so significantly? Often it is because market activity is relatively thin as a result of the other 99 percent being held constant. In other words, because of the persistent annual deficit in the U.S. balance of payments, there has been a huge accumulation of funds abroad, and in absolute terms the funds' movements may be considered massive while in percentage terms they may be no greater than they were in previous decades. Perhaps the reason why no one has been able to pinpoint a culprit for these large absolute movements might be because in percentage terms the movements are really relatively small and may not represent any noticeable change in anyone's behavioral patterns.

Senator PERCY. There is a staff memorandum that we have been working with that has this statement:

> With merchandise trade returning at the rate of approximately $5 billion per month each way, routine decisions by corporate treasurers to accelerate or slowdown payments by only a week or two could generate a full fledged currency crisis.

Would anyone care to briefly comment on that? Because we have other points we want to move on to.

Yes, Mr. Abboud.

Mr. ABBOUD. Senator, I would not only endorse your statement, but also, in order to answer your question very directly, I have never, in my experience, run across any company which has gone beyond normal hedging to try to make a profit on their foreign position.

Second, I have never run across a company where the announced policy of the corporation was that it should take a speculative position in foreign currencies simply because such speculation would skew the income stream and you would have a tough time next year trying to match it or exceed it in order to produce an orderly progression in earnings. I would say that, with the growth in trade and with the movement of goods back and forth between subsidiaries and their head offices in the United States, the volume as you have cited it would conform exactly with our experience, and that if you make any sort of a decision as to delay on the payment of payables, or on the receipt of receivables, this is going to have a very substantial impact in the spot foreign exchange markets.

Senator PERCY. In a one-word reply, could any of you either agree or disagree with the statements made by Mr. Abboud?

Mr. Hawes.

Mr. HAWES. I see no speculation.

Could I add one thing?

Senator PERCY. Surely.

Mr. HAWES. Strictly in a small way a market factor, a corporation which now believes that they should hedge their dollar position, to put it this way, and they have obligations in many different areas of the world, but they find there are market reasons—and this may be true in normal times, but particularly when pressures are on—that they cannot hedge certain currencies, they then pick the major currency that they feel more certain of and hedge the total position. Now, I have no evidence of this, but I feel sure it is true. And this will give an exaggerated move in that currency. And obviously, the one I would think of is the German mark in recent time.

Senator PERCY. I would like to move into another area. And I appreciate your comments on that point. I think they are very valuable. I would ask that the staff send this testimony over to the Foreign Relations Committee in the Senate on our multinational corporations so that we can insert that in the record there.

I would like to ask you about the role of gold. As I have quickly gone through your testimony, I have seen no reference to the role of gold in the international monetary system. We might have some discussion of it with Mr. Friedman this afternoon. The Senate overwhelmingly took a position on the rights of Americans to own gold as of the end of this year. I am serving on the House-Senate conference. We tried in this conference to make it at the end of the next year, or to extend another year beyond, but at some point in the future to say

that right does exist. I wonder if you could give a brief comment in your judgment on the place of gold and how you feel on this one question, an emotional question to a lot of people. Should Americans have the right at some time in the future to own gold? How would you vote on that if you were in the U.S. Senate or the House?

Mr. Abboud, do you want to start? If we could be very brief on that, I have one other area I want to get into.

Mr. ABBOUD. I could make three sentences on that.

First, I see no reason in the world why Americans should not have the right to own gold if it is just like any other commodity.

Second, it seems to me that we have over-reacted against gold the same way that we have conceivably over-reacted in favor of gold in the monetary system.

And third, it seems to me that there is no way that we can take gold completely out of the monetary system of the future, although it certainly should be deemphasized. And to the extent that we can deemphasize it, all our attention should be focused on that.

Senator PERCY. Mr. Hawes.

Mr. HAWES. I believe that Americans should be allowed to own gold at some time in the future. I don't believe that the time is one that we are in, the midst of what I call monetary turbulence. I think for that reason it can't be done at the present.

Senator PERCY. Mr. Leclerc.

Mr. LECLERC. I also do not feel that, given the situation under which we are laboring at the present time, it is either propicious or desirable to even set a fixed date for the holding of gold by American citizens. I think it would only add to the turbulence.

Senator PERCY. Mr. Prud'homme.

Mr. PRUD'HOMME. I would agree with these previous statements.

Mr. TECK. I also think that it is inappropriate to set a fixed date, because obviously the role of gold has to be worked out of the international monetary system before further dislocations in its price are caused by purchases of private Americans.

Senator PERCY. We will give Professor Friedman equal time this afternoon.

My last question is a more general question, and it goes almost to the philosophy and heart of what we have to do almost every day. It goes back to my fundamental belief that monetary and fiscal policy is more an art than a science, that it is an intangible sort of a thing. You build it up over many, many decisions that are made as to what happens to your currency abroad, and to the confidence that people have in it.

For example, we just cast a vote on the floor of the Senate on the land use bill. It was defeated. The proponents of the bill feel that the Federal Government should pay 90 percent and the States 10 percent on this program. I voted with the administration, which I don't always do, to make the bill a two-thirds-one-third split, just to simply make it so that it is not too cheap, so that the State has to spend more of its own money. I think that is a vote that has some influence, miniscule as it may be, on attitudes.

The votes that we are casting and the work that we are doing now is to bring congressional control back to the budgetary process to see that we exercise discipline. are other examples. Senator Ervin and I sponsored a bill which overwhelmingly passed the Senate and which

we sent to the House to put a ceiling of $268 billion on the budget, $700 million less than the President's budget. I think that happened to have an influence. I was one of nine Senators from a farm State to vote against the agricultural bill of the Senate, because I happened to think we were totally irresponsible. By putting target prices on we could raise our farm assistance base to $10 billion a year if we got back to 1971 prices. We acted on the hope that the House once again would act as a responsible body, almost the faith that it would, and chop all these figures down. But we passed a bill in the Senate that I think was utterly irresponsible. That to me is a vote that has some influence on the value of the dollar. And you can't wave the flag and say you are for fiscal responsibility, and day after day continue to vote against it. The Burke-Hartke bill is another terribly important vote against a responsible trade bill.

I also worry about the President's saying, we are going to put a limitation on food exports, after building all these markets abroad. If we are going to put a quota when it hurts us a little bit to trade abroad, we are not going to supply our customers. Interferrence with the normal market process worries me. That is a very broad philosophical statement.

But for guidance of legislators, is there any sense from your standpoint in saying that virtually every one of these decisions we make day by day has some effect upon this overall program of trying to have a stabilized currency in an international monetary system that in the future will do as much for us as the Bretton Woods agreement did in the past?

Mr. Abboud, would you care to comment?

Mr. Abboud. Senator, I would like to respond to that, because it would help to clarify the difference that I have with Mr. Teck in his testimony.

I think that by having instability in the currency we shift the imposition of intervention. We shift intervention and the imposition of controls from the currency area into other areas, whether it be the restriction of exports, or the movement of capital. And I think that in his very articulate position Mr. Teck did not address the question, Does not currency instability produce the imposition of controls, whether it be by our country or by others, which in the long run are going to be very disruptive to investment and trade?

Now, you have mentioned legislative action in the foreign area, you have mentioned legislative action in the budget area, and you have mentioned legislative action in other areas. All the legislation that takes place is going to have an impact on how stable the currency is going to be in world markets.

And when all is said and done, it isn't going to be the system that we adopt that is going to save us, it is going to be the extent to which we can exercise discipline on each and every piece of legislation that comes before the Congress.

Senator Percy. Thank you.

Mr. Teck.

Mr. Teck. I agree with you that every small decision that is made does indeed affect the international monetary system. If the dollar gets persistently weaker over a prolonged period, some people will probably say, that this indicates that the floating system isn't working. It may in fact be a reflection of an accumulation of small decisions that

could have had an even greater effect were it not for the floating system.

For example, if the President is successful in reducing our agicultural exports and permitting an increase in imports, this would adversely affect the balance of payments over the longer term. It is an accumulation of steps such as this that will weaken the dollar and not the floating rates.

With respect to the comment that instability breeds controls, I couldn't agree more. Thinking back to one example, at the end of World War II the French franc was worth 88 U.S. cents. At the end of the Bretton Woods system it was valued at about 20 cents. Throughout the quarter century dominated by the Bretton Woods system there was a series of large, disruptive movements, not only in that currency but in virtually all other currencies. Most important, the move from 88 cents to 20 cents took place in large quantum jumps. It is these big instantaneous shifts that give corporate treasurers the type of anxiety that leads to hastily conceived and often costly protection strategies.

To postpone these large quantum shifts as long as possible many countries imposed all sorts of trade and capital controls. The movements that are taking place now, large as they are, are relatively small, incremental movements when compared to the 10-, 20-, and 30-percent adjustments that took place throughout the Bretton Woods period. Many of the controls that exist today, which hopefully will be dismantled, are a legacy from past decades. For example, it was to get out from under the constraints of the Bretton Woods system that countries developed two-tier systems; they could at least partially float.

It is anxiety over the types of controls inherent in the two-tier systems and similar arrangements that gives corporations worries: which tier applies to their activities, will they be penalized for either being overdrawn or for having too much on deposit, for making a mistake? Should they continue international trade with all of the confusion and possible penalties? It is not the floating rates that are presently giving corporations their major problems with respect to international trade, but rather this proliferation of controls which is largely a result of the instability created by central bank intervention during the Bretton Woods system. In my opinion, the removal of these controls can be accomplished faster and most effectively under a floating rate system where incremental foreign exchange movements are considerably more predictable as to timing and amount than under any system that involves the possibility for destablizing quantum shifts.

Senator PERCY. Do you think that Secretary Shultz has cause to be concerned about a third-rate burglary that occurred in a local office building called the Watergate, and does that have a direct effect upon what we are talking about in the confidence of the dollar abroad? Could you explain why, as it would appear, that a totally unrelated incident like that could cause concern, and be something you can't put into your slide rule as to what the rate of the dollar is going to be this afternoon or tomorrow or next Tuesday afternoon, maybe?

Mr. TECK. The relationship that people are associating between the Watergate incident and the international weakness of the dollar is that there are many, many monetary problems, economic problems that the United States faces, and to the extent that the administration has to devote its effort to the Watergate situation, it is not able to give appropriate attention to these other matters.

There is great concern, particularly in Europe, about how much high-level attention is going to be directed away from the crucial economic issues of the time. It is wondered if these economic problems continue longer than they otherwise would have.

I think that is the causal relationship that is worrying many people.

Mr. PRUD'HOMME. Perhaps I could just add a word. I think, Senator Percy, that you are on the right track. I think that all these decisions do affect the behavior of exchange rates, and indeed corporate behavior in response to changes in those exchange rates. I raised the question earlier as to whether we should worry at this juncture too much about what monetary system we have, and whether we shouldn't worry a whole lot more about our own performance, political, economic, social, across the board. And furthermore, I think that if we in the United States are going to be an important factor—I think we should be—but if we are going to be an important factor in the trade and monetary negotiations which still lie ahead of us, we ought to get our house sufficiently in order so that we can participate in those negotiations from a position of strength. And that means generalized strength, not just pure military strength or pure economic strength, but from a position of self-confidence in ourselves, in our system. In that way, I think we could play a much more constructive role than if we are always self-doubting and tangled up with extraneous problems, so to speak.

Senator PERCY. Thank you very much indeed. And I would like to yield to my colleague, Congressman Brown, and apologize for taking so long.

Representative BROWN. I appreciate the opportunity, but I have just been called to a vote in a subcommittee where we are marking up legislation. I will have the opportunity this afternoon, I trust, with Mr. Friedman.

Chairman REUSS. Mr. Teck, in your long-prepared statement you say that the scenario to which you subscribe at this time seems to be that in the absence of any major regulatory or policy changes the outlook for the dollar in the months ahead is for further significant deterioration. Because a good many of the other witnesses have taken a more optimistic view, it may be helpful if you could spell out to us some of the reasons for your feeling.

Mr. TECK. That statement was a speech made on May 15 and written about 4 or 5 weeks prior to that date. What I was talking about is the subsequent events that have actually occurred. However, I do think, looking ahead for a relatively short period, that that statement continues to have some validity. I don't believe that the dollar will reflect any significant strength in the weeks immediately ahead.

However, I wouldn't be as forceful about it now as I was then as the situation is considerably different than it was a few weeks ago, especially in light of the significant deterioration that has already occurred. There is, however, a continuation of the Watergate problem. There are, as we mentioned, questions about the U.S. price performance under present controls and when a phase IV occurs. There are some questions about the effect of Mr. Nixon's export-import proposals on the balance of payments. There is a continuation of

higher interest rates abroad, even with the recent increases in U.S. interest rates. Additionally, to cite just one more example, the market appears to be worrying about the possibility of another German revaluation.

However, I think that words like strength and weakness can be very misleading, because people think weakness must be bad and strength must be good. Depending on the circumstances, there may be nothing inherently wrong with the dollar moving down relative to other currencies. In fact it may be just such a movement that ultimately speeds up the subsequent correction in trade and capital flows.

Chairman REUSS. In the short term, the decline of the dollar does make some of our products that are now getting scarce, like soybean meal, cheaper and thus more available to foreign purchasers. The dollar's weakness thus accentuates the tendency of people to get hysterical and call for broader export controls than are really needed, which Senator Percy and I at least regard as not a good outcome.

Mr. TECK. Then there is a basic question: Do we want to improve the overall balance of payments, and if so, are we willing to permit the adjustments that have to be made in the short run in certain sectors of the economy to achieve that, or do we want to develop a rather complicated, difficult to enforce system of controls which protect selected groups but which diminish the desired balance-of-payments effect?

Chairman REUSS. Let me put a question to you and see what you have to say.

We say we want to improve our balance of payments; and one of the reasons why the old pre-August 1971, exchange rates were in obvious equilibrium was that the dollar, by many tests, did seem to be overvalued then, and hence we are getting into economic troubles that could have been avoided.

However, zealous as I am for improving our balance of payments, exports, I wonder if it is really useful for us to let temporary speculative forces not based upon productivity, or relative rate of inflation, or even relative interest rates, but based on, as has been said here, one, the psychological fallout from the Watergate, and two, a rather distraught economic performance at home, in America, with insufficient attention to the inflation of the last 4 months. I wonder if we should accept this as something that fate has dished out to us and that we can't do anything about? The continuing depreciation of the dollar brings about hysterical reactions like, "let's put export controls on everything, because now our prices are getting so cheap that everything is getting sucked out of the United States." In short, wouldn't it be much better to concentrate on what really all five of our witnesses have said, namely, get our domestic economy in shape, and while this is the week in which we aren't supposed to talk about Watergate, nevertheless somehow have an end to that by a little clean breasting by those who are capable of doing it?

If we got rid of those two things, I would think that the position of the dollar would rise in a helpful manner. Whereas if you don't do anything about those things and try to goose it upward by ringing the market with central bank intervention, you simply betray your hysterical concern about what is going on, and your unwillingness to

do anything about fundamentals. All you do by the operation is lose a lot of taxpayers' money in a needless intervention.

Mr. TECK. I think there are ways of making use of natural market forces. For example, if one wanted legislation to strengthen the dollar during what is assumed to be a transition period until a more fundamental improvement can be acheived, rather than select certain sectors of the economy for preferential treatment, perhaps it might be more equitable to impose more general legislation. For instance, all exporters might be required to request shorter payment terms or even immediate payment. By making use of the fact that there is a normal profit incentive to export and by requiring payment immediately, demand would be created for the dollar in the short run. There are also many other ways to create such a demand without selectively going to various sectors and creating a great proliferation of controls and the associated bureaucracy. However, I hasten to add that I do not recommend any action of this type, either general or specific; it is unnecessary, difficult to enforce, invites retaliation and would probably be ineffective over any extended period. The obvious alternative is to improve the U.S. economic performance.

Chairman REUSS. Mr. Prud'homme.

Mr. PRUD'HOMME. I wonder if I could approach this from a slightly different angle? I would certainly agree that this is not the time to try to goose up the market or goose up the dollar in the markets.

Chairman REUSS. By intervention methods?

Mr. PRUD'HOMME. By intervention methods.

Chairman REUSS. It is a great time to goose it up by going straight and living right.

Mr. PRUD'HOMME. Absolutely correct.

Furthermore, I doubt that we could do it under present circumstances. First of all, such intervention would itself be interpreted by the markets, I believe, as an indication that things weren't going properly, and that not only the private sector was upset, but now the governmental sector—through the Federal Reserve Bank and the Treasury—was beginning to get upset.

Second, when the United States intervenes, if it ever does, it can't do so all by itself, it has to have at least one other central bank working with it. And the fact of the matter is that since our economy is so large and so influential, the Fed usually has perhaps as many as six or a dozen other central banks cooperating with it. I doubt that at this time it would be physically possible for the Federal Reserve to enlist the support of other countries to buttress or somehow undergird the difficulties that we are having domestically in this country at the present time.

Chairman REUSS. Why don't you start a d'Estaing-do-it on the part of the central banks?

Mr. PRUD'HOMME. Yes, sir.

Chairman REUSS. Mr. Leclerc.

Mr. LECLERC. I don't think it would be in the United States interest to see the dollar continue to depreciate internationally. I think it does create a certain type situation whereby goods are definitely sucked out of the U.S. economy. And I think one thing we have to keep in mind is the question of confidence of the people abroad, or the lack of confidence in the dollar. I think that has made people

react to something like Watergate in a rather unusual fashion. The majority of people that you speak to who operate daily in the foreign exchange markets will concede that regardless of the outcome of Watergate, it is not going to change anything. The dollar will still be in exactly the same position whether it is on the strengthening side or on the weakening side regardless of the outcome. And I think the very fact of the lack of any kind of orderliness in the market—we have had some extreme rundowns in the value of the dollars over a very short period of time, and I think this disorderliness is what creates the psychological and emotional atmosphere in international money markets that allows something such as Watergate to have such a dramatic effect on the markets. I think a predetermined type of intervention by central banks under any effective guidelines is certainly not advisable, because as has been pointed out earlier, it does give a target for the speculator to aim at. But I think there are ways that some sort of orderliness could be brought into the markets which in the long run I think it would be in the best interest of the United States and of our trade and investments, by perhaps less overt intervention by, say, the Federal Reserve bank, than that which has been utilized in the past.

I think if we look at the experience of some of the other central banks, we must, with very few exceptions—and I can think of 1967 as a primary one—the Bank of England has certainly been very astute in their type of intervention. Many, many times they are in the market and people aren't even aware of it. But they do create and establish a certain type of equilibrium that allows the normal market forces of supply and demand to come into play and to remain a little bit more in balance than we have seen now.

I think people stay out of the market in the hopes that tomorrow the dollar will be 1 percent lower than it was today, and we will have a 1 percent profit, instead of going in and covering the requirements as they come up.

Chairman Reuss. If you were a Swiss investment adviser, would you be advising your account in Switzerland to buy, let us say, American shares in a closed end investment trust selling at a discount, on the theory that, in addition to the discount, the overall Dow-Jones average has a very favorable price-earnings ratio and that there is also an opportunity to buy dollars rather cheaply? Hence, there would be a three-way affirmative factor to overcome all the negatives, like the possibility of a recession?

Mr. Leclerc. I think, from what I gather from speaking to not only Swiss but other European investment counselors, that there seems to be a general tendency today to advise their investment customers to invest in the United States, as the dollar is undervalued. And I heard it put just last week by an Italian investment counselor, he said he was telling his investment customers, if the dollar should depreciate another 2 or 3 percent in the interim, don't worry about it, because it is only a short run thing. I happen to be a little bit more optimistic with respect to the nearer term outlook for the dollar.

I think all we need are another 2 or 3 months of fairly respectable trade figures. And I think we can see the climate change quite considerably. The general feeling in the market early this week is waiting

with bated breath for the publication of the trade figures for the month of May.

Senator PERCY. I thought you were going to say, waiting with bated breath for the publication of the Dean papers.

Mr. LECLERC. I think that is beginning to lose a bit of its importance overseas, I think they are getting a bit tired of it.

But we have had many, many inquiries from our counterparts overseas trying to get the precise date and timing of the release of the May trade figures. I think this indicates the degree of importance that the international money markets have placed on the trade figures to date. I think we tended to ignore them for too many years, but now they are an important factor.

Senator PERCY. Have you talked to Henry Kearns lately?

Mr. LECLERC. No.

Senator PERCY. He is very optimistic. I hope it is not an over-optimist, but I think he is feeling comfortable about the trend we are experiencing. And I hope these figures will be available.

Chairman REUSS. Do you have any additional questions?

Senator PERCY. I have a couple of areas, Mr. Chairman.

Chairman REUSS. Mr. Hawes, do you want to add something?

Mr. HAWES. I wanted to speak to Senator Percy's comments on all matters.

Indeed, last Thursday morning, as I am sure my friend Bob Leclerc heard from friends in Europe, the fact that in the administration's presentation the night before there was no comment whatsoever—and maybe it couldn't have been put in that formal way—about control of the foreign exchange or willingness to do something of this—and they pointed specifically to the things that you mentioned about the control of agricultural exports, these little things continue particularly at a time when confidence has reached such a low point to only add to it.

My feeling about intervention—and I think it is very much what Mr. Leclerc has said—is that alluding to a certain point—I don't know what this is, this is a difficult point of decision—may pass the point that stability can be retrieved. And that would be foolish for everybody, very costly.

Senator PERCY. Thank you.

Mr. Abboud has said in his prepared statement—he points to Mr. Kemeny of Dartmouth College stating:

> The key to a complex system is to find that gland or pressure point where delicate adjustment will radiate and mangify it throughout the system.

I would like to ask you about interest rates. If, for instance, the Patman theory prevails that you can freeze interest rates and regulate them by law and drive them down, and that will keep money cheap for everyone, and everyone will feel happy, if that really was allowed to operate, what would really happen, if interest rates could not reflect the normal demand and supply situation for money? A brief comment from any of you.

Mr. Abboud.

Mr. ABBOUD. I would very much like to comment on that. I think a good deal of the trouble we are having today is because we have artificially suppressed the rates for larger corporations and therefore

stimulated more demand, more borrowing in the market than otherwise might have occurred.

Senator PERCY. They recognize that money for them is very cheap, then.

Mr. ABBOUD. Absolutely. We have situations where customers are borrowing from us at 7½ percent and 7¾ percent and turning around and buying our own CD's for 8.4 percent. Now, that is our business to make that spread, not their business. But that is what is happening. You are right. This is creating great disturbances in the market.

Mr. HAWES. In the exchange market, Senator Percy, in early 1972 following the Smithsonian, and again following the change in February of this year, the interest rate factor, and our determination to keep interest rates down, played a big part in the continuing disturbance in itself. The rules of the game seem to have changed, and I think many economists say that, but the new rules haven't yet been set up. And that seems to be one international rule particularly with our friends in Western Europe that they look to. And we decided to do it differently, and it didn't go down well.

Senator PERCY. I would like to ask in another area a comment on Mr. Abboud's statement that we should be willing to surrender some national autonomy or self-interest to attain a joint undertaking. It is a great principle. Now let's apply to to specific cases.

The President in his message the other night indicated that we are not going to let high food costs in this country come about if it means they are caused by large exports abroad. And, therefore, the Congress is being asked or will be asked to legislate regulations on exports of foreign products.

In your judgment is this good, sound policy for us to follow? It sounds awfully good to the consumer, and not too good to the farmer. But after all, there aren't too many farmers left, 4 or 5 percent, they don't have many votes, there are a lot more consumers.

Is it good economics? Is it good politics in the long run? Because I don't think good politics is good politics unless in the long run it is good economics in this kind of a case.

Suppose we rotate a little bit and rotate back to you, Mr. Abboud.

Does anyone care to comment on the other side of the table?

Mr. PRUD'HOMME. This is a pretty broad philosophical question also.

Senator PERCY. I am talking about a specific piece of legislation we are going to be asked to vote on. It will be looked upon as a consumer piece of legislation, I suppose. Keep prices down by not shipping all our food products abroad when we have some levels of scarcity, much more than we have ever had in 30 years at home. It is all relative.

Mr. PRUD'HOMME. I feel, though, Senator, that if every government takes this point of view of protecting their own consumers first and foremost, and indeed the elected representatives of the government protect their own skins in their own electoral processes and parliaments and so on, that the future is much bleaker than I hope it is going to be—and would be bleaker than it has been in the past. I really think that somehow we have to return to some sort of norms or rules of appropriate international behavior. And that, of course, means appropriate national behavior as well, and to avoid the

tendency to look more and more in a self-interested way—and I am speaking now as a nation or as a country—a self-interested way vis-a-vis the outside world.

And this, I think, comes back to the exchange rate problems, the questions about controls, the questions about artificially increasing or decreasing interest rates, a whole series of problems which are economic. I don't really see how, if we all take a strictly self-interested point of view, we are going to reform our monetary system in an appropriate fashion. How are we going to obtain very many concessions in the trade negotiations, reciprocal concessions, I mean, from our friends and allies abroad? I hope they will remain friends and allies, and will not become simply antagonists.

Senator PERCY. The others who might want to comment on this question, could you also expand it to include the Burke-Hartke philosophy of arbitrarily requesting new quotas on part of the average of 65 to 69 imports which would certainly roll back imports a fantastic amount, and which presumably will save jobs here at home. I happen to know that is the most outrageous piece of legislation ever supported by the AFL–CIO, and I have told George Meany that.

Would you care to comment on the bill as a means of taking a nationalistic approach which in the short run may seem to our advantage but which would certainly be disastrous, I think, in the long run.

Mr. LECLERC. Senator Percy, I think we have all pretty much taken the position that we live in fear of a proliferation of controls, whether they be exchange or trade controls. And I don't think that either way they can possibly serve our best long-term interests.

Mr. HAWES. I wonder if the Burke-Hartke matter isn't comparable to what we knew in the beginning thirties, which was the worst tariff we ever had in our history, I believe, in the Smoot-Hawley Act. There are a lot of differences, of course. But I think it would be a disaster.

Senator PERCY. Mr. Abboud, you raised the issue.

Mr. ABBOUD. I think this is really at the heart of the matter. There is a very definite link between what happens to our exchange rate internationally and what we do domestically. And if the dollar goes down further, we are going to add to the scarcity of some of our export commodities, we are going to make imports more expensive, and whether we do that in the form of the Burke-Hartke by setting up quotas or by pricing them out of the market, this is going to add to inflation in the United States. There will be tremendous political pressure for the imposition of selective controls that Chairman Reuss has talked about. I admire the philosophy that maybe if we fly right and come clean this will take care of things in the short run. I don't happen to believe that things work that fast with that kind of an attitude. I think we have an artificially depressed dollar with Watergate which is overexaggerated in the world markets, and it is a beautiful time for intervention right now, because there is no way you can lose by doing it. And if the pressures mount for controls, as the President has indicated, and we put these curbs on our exports, it seems to me we do inestimable damage to our markets abroad.

The Japanese are counting on us for their food imports. And now all of a sudden we tell them we are going to shut them off. Obviously they are going to look for other suppliers.

The same thing can be said for negotiations now on the citrus agreement. They said, how dependable a supply is the United States if every time they get in trouble they impose controls?

So I would say if you have the choice between regulating the exchange rate which applies equally across the board to the economy, or letting the exchange rates fluctuate artificially too far down or too far up, and then apply selective controls on particular exports of a particular industry, the latter is selective, it is pernicious, it is arbitrary, and it is much less desirable than intervening in the markets.

Senator, I think in any sort of an agreement that we have abroad means that we assume burdens and responsibilities. Otherwise there is no such thing as an agreement.

And I agree with Mr. Prud'homme that we ought to get our own house in order. But I think before we can get our own house in order we have to understand and agree among ourselves what burdens and responsibilities we are willing to assume. And once we have made that, then I think we can get at the job of doing it domestically.

Senator PERCY. The last area that I would appreciate your counsel is in the area of capital investment, and increasing the productivity. I think we have to link with that question this one. We can look at the steel industry, which in the past has gone on strike and shut themselves down, with a limited supply, and cut their foreign customers off. This caused a loss of confidence and the need for a steady source of supply to domestics. The unions just undercut themselves to the point where now I think Mr. Abel is one of the most progressive far-reaching, far-thinking men in organized labor. By a no-strike pledge, and product councils in every plant, they are really working to build up the markets they have destroyed themselves over a decade or two of that kind of industrial relations policy. They certainly have soul-searched and are on the right track now.

Investment of capital is necessary to increased productivity. We have a part in that, because of the investment tax credit and amortization depreciation schedules. I have fought hard to get the 20-percent flexibility that we now have built into the internal revenue code, and to make the 7-percent investment tax credit a permanent part of our structure and not something to be turned on or off. But just to have an open mind on it I had breakfast last week with Arthur Burns to talk about his concept of a fluctuating need. His concept would involve new legislation. Because it may be coming up for decision could you give us your comments? If you had a rate that couldn't go below, say, 3 percent, but could go up to 15, and if the President could impose, subject to reversal by Congress in a reasonable period of time, say 30 to 60 days, do you think it would be worth our considering having a flexible rate that in times of over-production, boom periods, we could drop that rate to 3 percent, and in times of recession, when we need to stimulate business activities, we could go up to 15 percent?

Chairman REUSS. Senator Percy, before the witness responds, I would like very much to hear the answer to this question, which interests me, too.

I have a call on my side of the Capitol. Would you be kind enough, therefore, after you explore the matter fully, to adjourn the hearing until 2:30 this afternoon?

Senator PERCY. I certainly would.

Chairman REUSS. And I want to thank the members of the panel for an extremely helpful discussion.

Senator PERCY [presiding]. We thank you, Mr. Chairman, for calling these hearings.

Here I ask you for guidance, because a great many of us really need help in this area. I am sending a questionnaire out that I have developed with Mr. Burns to some leading businessmen and industrialists. In a quick, just very quick, meeting with the board of directors of Illinois manufacturers the day before yesterday, I found them so afraid of losing the 7, even if it could go on up to 15, that I think they would rather keep the status quo. This is the first quick impression I have from my own State.

Would any of you care to comment?

Mr. PRUD'HOMME. I will take a crack at it.

My own feeling is that if you use fluctuating or flexible methods domestically, they are a whole lot more satisfactory than similarly fluctuating or floating methods internationally. I think the question is largely a domestic question, although it has long-range international implications. I for one would vote for creating a somewhat more flexible investment credit mechanism. And this is on the assumption, of course, that this administration and future administrations will administer it in a reasonable manner.

Mr. TECK. One aspect of this question is that there will probably be dislocations as a result of businessmen's expectations. For example, if there were a slowdown in business investment sufficient to cause an increase the investment tax credits, businessmen would anticipate this possiblity and would postpone their investments in expectation of the increased credit. Such postponement would produce a self-fulfilling prophesy.

Once again I am not so sure that Government intervention in the marketplace is appropriate even in this area.

Returning to two of your previous questions, however, I find a link between them. One of the problems that has occurred recently is that, by keeping a ceiling on the level of interest rates, monetary policy has become ineffective. Many businessmen have been borrowing at relatively low-interest rates, including a lot of anticipatory borrowing with monetary policy made ineffective by controls on interest rates, the Government has felt forced to turn to something more difficult to administer and a good deal less effective; namely, a new tool, which is the proliferation of price controls.

Maybe the Government should restore the cutting edge of monetary policy by removing interest rate controls, and, at the appropriate time, also remove the price controls that were largely generated by the fact that monetary policy has been made ineffective. There may be a near-term possibility for removing both sets of controls to the underlying advantage of the U.S. economy.

Senator PERCY. Mr. Abboud.

Mr. ABBOUD. Senator, this is a very difficult question.

Certainly there are great advantages in being able to cut the investment tax credit down to 3 percent at a time of full capacity, such as the moment when we want people to defer their orders and to defer the expansion of investment.

And on the other side of the coin, investment decisions tend not to be short-run types of decisions. You make a decision to build a plant

and you hire the architect, and it usually takes a long time. And if in the process the rules of the game change, then you have to put all of your analysts and forecasters to work to make different cash flows to see whether you want to go ahead with the decision. I think in the long run we are going to have to refurbish the entire plant of the United States in order to remain competitive in a world which will not have any tariff barriers. It may be more advantageous to have the element of certainty, of figuring what the investment tax credit is going to be over a longer term in order to get the broader benefit of substantial investment in the capital plant of the United States, than to have the desired flexibility of trying to shut off the faucet during time of overemployment. It is a very difficult question, and you could make a very reasonable argument on both sides. But it seems to me our long-run problem is to get this country back in the manufacturing business, so that we are without parallel as a manufacturer on a worldwide basis.

Senator PERCY. I agree with that. And I also agree and feel that there is a tremendous amount that labor and management have in common here, that the two must cooperate. Here again I have disagreed strongly with the AFL–CIO position on investment tax credit. They called it a big gift business.

There couldn't be anything further from the truth. There is nothing that will protect our ability to hold jobs and keep jobs in this country and keep manufacturing aggressively here than to pour the capital behind American labor to make it highly productive. And that is why I have sponsored legislation that is authorizing supporting and funding for a National Commission on Productivity, to hopefully create productivity councils across the country to better understand the nature of the common objective labor and management have.

The only way we can preserve the strength of this economy is through an economic base. We can't sit here and pass laws and hope to do it. It has got to be fundamentally sound economically. Certainly if we do not stimulate capital investment and back up American labor, the most highly educated in the world, we are going to find that labor force very unhappy and dissatisfied with manual jobs. They want a greater challenge. And that gets in the whole problem of the quality of work performed, a problem that is plaguing certain industries today.

Your testimony has been extremely valuable, and much appreciated. I would like to leave the record open for one further question that I feel you may want to consult with your associates on, and either send to me in confidence, not for public record, or for transmittal to the administration, or for public record. It is a question on phase 4 guidelines. I think that phase 4 will have a significant international impact. We made a brilliant decision August 15, a couple of years ago, and we moved quickly to get off the wicket. It gave us a chance to realine ourselves. I was never so shocked in my life as when we moved into phase 3 before we had really done fundamentally those things necessary to justify moving in, and we have had now to disastrously take another look at it for 60 days.

But what we develop in this 60 days is the important thing. What do you feel should be included in these guidelines in phase 4, particularly from a standpoint of those things necessary to assure the world that they can have confidence in the dollar, and that we intend

to undertake that hard, nitty-gritty type of work necessary to lay a foundation that will be a solid foundation for the dollar in the future? And those policies are under consideration and advisement. We want to be helpful and cooperative with the administration. We want to work together. We have a community of interest. I would very much appreciate your letting me know directly what you think in your judgment should be done. I can assure you that I will communicate your comments either openly by insertion in the record, or confidentially to the Secretary of the Treasury and to the domestic council. I am sure they will certainly be anxious to have the benefit of your point of view.

With that I have a vote on the floor of the Senate. Unless anyone has a hasty comment that they would like to make, these hearings then will be recessed. Our gratitude to you as a committee for your invaluable contribution today.

We will recess until 2:30 this afternoon.

[Whereupon, at 12:25 p.m., the subcommittee recessed, to reconvene at 2:30 p.m., the same day.]

AFTERNOON SESSION

Chairman Reuss. Good afternoon.

The Subcommittee on International Economics will be in session for a continuation of its hearings into the question of how well fluctuating exchange rates are working.

This afternoon we shall hear from three distinguished economists, Mr. Ricardo Arriazu, Alternate Executive Director of the International Monetary Fund; Mr. Milton Friedman, professor of economics, University of Chicago; Mr. Allan H. Meltzer, professor of economics in the Graduate Schools of Industrial Administration of Carnegie-Mellon University in Pittsburgh.

Gentlemen, we have received prepared statements from each one of you, which under the rule and without objection will be printed in full in the record.

We would now like to ask you to proceed in your own way to summarize, read, extemporize, any way you want.

Mr. Arriazu, would you lead off, sir?

STATEMENT OF RICARDO H. ARRIAZU, ALTERNATE EXECUTIVE DIRECTOR, INTERNATIONAL MONETARY FUND, WASHINGTON, D.C.

Mr. Arriazu. Thank you, Mr. Chairman.

I would like to express how pleased I am to be invited to testify before this subcommittee. I have already handed to you my prepared statement.

I would like to emphasize that the points of views presented in this statement are my own and in no way an attempt——

Chairman Reuss. Would you identify yourself, Mr. Arriazu? You are an Alternate Executive Director of the Fund?

Mr. Arriazu. Yes.

Chairman Reuss. What countries?

Mr. Arriazu. My own country is Argentina. We represent Argentina, Uraguay, Chile, Bolivia, Ecuador, and Paraguay.

I wanted to emphasize that this statement is made in my own capacity entirely. I am in no way attempting to express the official point of view of the International Monetary Fund.

I have circulated my prepared statement, and I would like to emphasize some of the points included in that prepared statement.

At the outset I would like to express three points.

First, that I do not consider that the present system can be characterized as a floating system. As a matter of fact, even though we have a large number of major currencies floating including the dollar, we have probably the widest combination of exchange systems ever with the exception perhaps of the 1930's.

I think that to summarize the present system it is better to point out that at present we have 10 countries floating with different degrees of intervention; we have 8 countries floating as a bloc, maintaining a very close relationship among themselves, but with no obligation whatsoever to defend a rate with respect to the dollar; and we have 24 countries that have pegged their currencies with respect to the dollar; 14 with respect to the French franc; and 11 with respect to the pound; and we have 53 other countries that have either declared central rates or par value which they defend by intervening in any of the 3 above-mentioned currencies.

So that I will say that from my point of view the present system would be best described as a mixed system of floating and currency blocs.

The second point that I wish to emphasize is that it is perhaps too early to judge the efficiency of the new system. Changes in systems are always accompanied in the early stages by disturbances until the relevant variables settle into a viable structure.

The third and final point is to indicate that it is possible that the recent fluctuations in exchange rates are the result more of the special circumstances under which floating was introduced rather than a consequence of floating itself.

Now, developing countries, confronted with the decision adopted by the main industrial countries on March 16, had only two alternatives open to them. One was to let their rates float independently, and the other was to peg their currencies with respect to one of the major currencies. All developing countries, with the exception of Lebanon, which was floating before, chose to peg their currencies in relation to one of the major currencies. And as a matter of fact, the majority of the countries chose to maintain their traditional rate in relation to their intervention currencies. And I would like to emphasize the word traditional.

I have tried to analyze the impact of floating on the developing countries from two points of view, which are included in the prepared statement: One is the impact on trade, financial flows, and domestic policies of the countries involved; and the other is the effect on international liquidity and the prospects for reform of the international monetary system.

Chairman Reuss. May I interrupt for just a moment to say to Mr. Friedman and Mr. Meltzer that we particularly wanted here a thoughtful representative of the less-developed countries, because it has been borne home to me in recent weeks, from talking to the experts who represent these countries, that there is in their minds a problem

with respect to fluctuating exchange rates. And I know you are going to listen with interest to Mr. Arriazu's statement. And I might possibly ask you to come back at him.

Mr. ARRIAZU. Thank you, Mr. Chairman.

I should have clarified at the beginning that I was attacking the problem from the point of view of developing countries.

Now, on the subject of trade, financial flows and the effects on domestic policies, I think that we can find three main aspects in which developing countries are interested. We are interested in the effect of floating in the adjustment process of developed countries, we are interested in the effect of floating in our own adjustment process, and we are interested in evaluating whether floating results in any cost particular to the developing countries that were not present before.

Insofar as the present system of floating tends to improve the adjustment process of the developed countries, it will facilitate the growth of trade and financial transactions, and will work in favor of developing countries.

We are interested therefore in an improvement in the adjustment process of the developed countries.

Floating up to now has not avoided crises, although it has changed the characteristics of them. Up to now crises took the form of massive movements of reserve, but now they take the form of movement in exchange rates.

I have to clarify my statement to insist that probably some of these movements are characteristic of the early stages of the floating system, and on the other hand they are also characteristic of the special circumstances in which floating was introduced. And I am referring in particular to the overhang and the confidence problems of the dollar. So in this respect if floating helps to eliminate or dampen destabilizing forces in the developed country it will probably be useful for developing countries.

However, this change in the characteristics of crises has a direct adverse effect on developing countries. Up to now developing countries were only marginally affected by floating among the major currencies. They were affected when crises forced the closing of the markets, they were also directly affected by some flows of capital to and from developing countries. But now any crisis or movement of capital will be reflected in a movement in the exchange rate of developed countries. Since our currencies are tied to developed countries, more precisely to the currencies of developed countries, the effect will be that from the point of view of developing countries, their effective rates are not being moved by their own balance-of-payments needs, but from the point of view of the needs of the developed countries. So in this sense I would say that this is the worst effect of floating on developing countries.

I have also tried to mention some of the direct costs that the introduction of floating has had in developing countries. I have included in my statement an examination of several of these additional costs. I wouldn't like to repeat them, except to mention that some of these factors result in small costs, some have bigger costs, some are due to floating itself, while others are due to the particularly wide fluctuations of rates in the early stages of floating.

So in summary I will say that from this point of view floating—I better not say floating, but rather say the present system—has been detrimental for the developing countries.

Now, the second aspect that I have tried to cover was the effects of floating on international liquidity. Floating, together with currency blocs, has probably decreased the liquidity needs of the main industrial countries. Simultaneously with floating, European countries have introduced a new system of multicurrency intervention which requires perhaps greater liquidity than a single currency intervention. They have, however, also extended the network of swaps that they have available to finance the additional needs of liquidity derived from the new system of intervention.

Due to the fact that they have pegged the value of their currencies to a floating intervention currency, developing countries will need more liquidity than before. The effective exchange rates of developing countries will not be adjusted in accordance with their balance of payments needs but in accordance with the balance of payments needs of their respective intervention currencies. Adjustment will, in general, be destabilizing and will therefore require more liquidity than before. In addition, they would need to diversify the composition of their reserves increasing their needs for liquidity, and finally, they would also have to hedge against exchange risks and this will diminish interest rate differentials, decreasing the flow of financial resources.

All this in effect implies that developed countries will have very little incentive to favor allocations of SDR's, while developing countries will have a higher need of liquidity than before. We have been satisfying our own need for liquidity very much through the allocation of SDR's. If, now as a consequence of the introduction of the new system there is no allocation of SDR's we will have then to satisfy our own liquidity needs through a transfer of real resources to reserve centers. And at this point this also will be detrimental for developing countries. But I want to emphasize that this is not a point that is a direct consequence of floating, but rather a consequence of the mixed system that we have at the present moment.

Developing countries have expressed on many occasions the type of system that they would like to have in the reformed system. I would like to quote from the communique of the Intergovernmental Group of Twenty-Four on March 24, 1973:

> Developing countries have expressed on many occasions their support for a reformed international monetary system based on an efficient, equitable and symmetric intervention system and the collective management of international liquidity through a strengthening in the role of SDRs (and consequently a decline in the role of reserve currencies and gold). They have also stressed that the system should ensure adequate transfers of real resources to developing countries.

As far as we are concerned, the present system will probably help achieve the first of these objectives, but will not help in achieving the other two. So the question is, is there any other system that will help the simultaneous satisfaction of the three objectives?

It is my own belief that a system of adjustable parities together with more frequent and smaller changes in par value, complemented by international surveillance to assure an adequate process of adjustment, will be more beneficial to developing countries than the present system.

I have also tried, Mr. Chairman, to answer your second question in the prepared statement. And I wouldn't like to go over this matter now.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Arriazu follows:]

PREPARED STATEMENT OF RICARDO H. ARRIAZU [1]

FLUCTUATING RATES, CURRENCY BLOCKS AND THE DEVELOPING COUNTRIES

INTRODUCTION

The subject on which we have been asked to comment today is "How well are Fluctuating Exchange Rates Working?", a subject which I will focus on from the very particular point of view of a small country with imperfect or underdeveloped exchange and capital markets and with little power as an individual country in the international decision-making process. Of course, most developing countries fall under this definition, but some developed countries would also be covered by it.

I would like to emphasize at the outset that even though the present system of exchange rates contains a large number of fluctuating currencies—including the main intervention and reserve currency, i.e. the dollar—it cannot be characterized, in my opinion, as a floating system; as a matter of fact the present system contains the largest simultaneous combination of exchange rate systems ever, with the exception of, perhaps, the 1930's.

The most convenient and illustrative method to summarize this system is to indicate that at present there are: ten countries that are floating independently with various degrees of "guiding intervention"; eight countries that have agreed to operate as a currency block, maintaining a close relationship (2.25 per cent maximum margin) among themselves and with no obligation to defend an established exchange rate vis-a-vis the dollar; 29 countries that have elected to maintain a fixed relation to the dollar, 11 a fixed relation to the pound sterling and 14 a fixed relation to the French franc. In addition, 53 other countries have declared either par values or central rates, but have in fact pegged their currencies to the three aforementioned currencies. In summary, the system can, at best, be classified as a mixed system of floating and currency blocks.

A second aspect that I would like to emphasize at the beginning is that it is perhaps too early to arrive at a judgment on the efficiency of the present system and in particular on the efficiency of floating rates. Transitions from one system to another are generally accompanied by disturbances and adjustments of the different variables and factors to the new order.

The exchange rate system put into force by the main industrial countries on March 16, 1973, was introduced primarily to achieve two objectives: 1) to isolate their domestic economies from the effects of the massive speculative capital movements which have confronted the international monetary system in the last few years and, thus, to avoid the accumulation of what for them are unwanted inconvertible dollars, and to preserve at the same time regional structures and regional agreements; while, 2) creating enough risks, incentives and disincentives through fluctuations in exchange rates to eliminate, or at least to dampen, such speculation. Some countries have, on the other hand, chosen to let the value of their currencies fluctuate, rather than to establish a fixed rate, because they feel unable to determine a viable rate until the whole structure of rates settles into a stable pattern. These considerations should be taken into account when judging the functioning of the new system. I will refrain from commenting in detail on how the system has operated in practice, except to indicate that it has not—at least until now—eliminated crises, although it has tended to reduce the volume of funds involved in such crises; and, to point out that the intensity of such crises can no longer be measured primarily by the volume of the movements of funds but instead have to be measured by the magnitude of the exchange rate fluctuations. These movements do affect international transactions and therefore domestic economies and may induce, in the absence of surveillance and agreements, the adoption by the countries affected of counter measures on trade.

Countries' past experience with floating seems to indicate that wide fluctuations of exchange rates in the early stages of floating is a normal occurence uutil the system settles into a viable structure. Present fluctuations seems to originate

[1] The points of view presented in this paper are my own, and in no way attempt to represent those of the International Monetary Fund.

more in the particular circumstances in which the floating was introduced than in the characteristics of the system itself. The confidence problem of the dollar may have contributed to these fluctuations.

Other countries, confronted with the system imposed on them on March 16, had only two alternatives: either to continue to peg their currencies to one of the major currencies, or to let the value of their currencies float independently. All developing countries, with the sole exception of Lebanon, chose to peg the value of their currencies to a major currency (the immense majority of developing countries chose to maintain their traditional rates in relation to their respective intervention currency). That decision means in fact that if a country pegged its currency to the dollar, it will float along with the dollar in relation to other currencies. Floating will therefore have important effects on the economy of developing countries. Most of these effects result from the system of floating but some originate in the particular economic circumstances under which the floating system was introduced. I will attempt to review only some of these effects.

Effects on Trade and Domestic Policies of Developing Countries

To evaluate the overall impact of floating on developing countries it is necessary to examine not only the direct impact of floating on their economies but also the effects of floating on the world economy. Developing countries are interested in the smooth functioning of the international monetary system as a whole. A malfunctioning adjustment process, which tends to perpetuate disequilibria rather than to correct them and which tends to give rise to disequilibrating capital flows, is clearly detrimental to the interests of developing countries. Insofar as the present system of floating and blocks tends to improve the adjustment process and to deter disequilibrating capital flows, it would make a positive contribution to the growth of trade and financial flows and would be in the interests of developing countries.

As indicated earlier, it is too early to judge whether or not floating has contributed to improving the adjustment process. Fluctuations of the main exchange rates have been substantial since the introduction of floating; such movements have in general occurred—and progressively so—in response to leads and lags in trade. The overall level of international trade does not seem to have been affected but the adverse effects of leads and lags are obvious. In addition, fluctuation of rates have resulted, at least momentarily, in a structure of rates which might be inadequate for long-run equilibrium. Also, as indicated earlier, floating has not yet eliminated the recurrence of crises, although they now take a different form. One consequence of the changes in the nature of the crises has been that developing countries which were previously only marginally affected by such crises, are now directly and adversely affected by them. Under the earlier system, destabilizing capital movements occurred mainly among developed countries: closing of the markets and some capital movements from and to developing countries did have some adverse effects on developing countries, but they were small compared with those affecting the countries directly involved. At present, any movement of funds that results in wide fluctuations of exchange rates will also affect the exchange rates of developing countries vis-a-vis the countries involved. These movements in rates are not related to the adjustment needs of developing countries and therefore could in general be considered destabilizing.

One immediate consequence of the introduction of floating has been that exporters from strong currency countries have started demanding that their operations be denominated in their own currency thus transferring the exchange risks to developing countries. Differences in bargaining power leave no doubt as to the final outcome of such pressures. It is almost impossible to ascertain at present what the future structure of these currencies will be but it is clear that the cost of "hedging" against the risk of changes in exchange rates will increase the cost of developing countries' imports. To be fair, it should be recognized that the risk of changes in exchange rates also existed in the fixed parity system and that exporters might have protected themselves against such possibilities including the cost of hedging in their export prices. A close examination of the behavior of the three-month future rate indicates, however, that the cost of such hedging has, even after two general realignments, increased since the introduction of floating. By a similar line of reasoning, it is also possible to conclude that if fluctuations continue to be large, exporters of developing countries will also have to protect their export proceeds from exchange risks.

There are many other ways in which wide fluctuations of the rate of exchange may affect the trade of developing countries. One of the most important is the effect of floating on commodity stabilization agreements. The negotiation of com-

modity agreements is one of the ways in which developing countries have tried to protect their economies from wide fluctuations in commodity prices. On occasion these agreements have been concluded with the participation of consumers, and on other occasions exclusively among producers. Participating countries belong to different blocks (as indicated by their respective intervention currencies). Floating among blocks also implies floating among the participants of those agreements and gives rise to strains. Many commodity agreements will therefore have to be substantially modified in order to be able to function.

Another danger of the present system originating in the special circumstances in which it was introduced rather than in the nature of the system itself is the possibility that the resulting structure may provide domestic producers with false incentives. The last few crises have been generally classified as originating in a "confidence problem" rather than a fundamental disequilibrium. If this is the case the present state of flux and the resulting structure of rates may last longer than originally thought. These structures may result in the creation of incentives and disincentives and in the establishment of a productive structure which is incompatible with the long-run structure of exchange rates. This possibility is very real and dangerous for developing countries which have a very simple structure of production and which in many cases do not have the organization, information and knowledge required to successfully forecast future events. As an example, it is sufficient to recall that some developing countries have stopped operating simultaneously in several currencies for lack of arbitrage facilities and operate exclusively in their own intervention currency.

Wide fluctuations in exchange rates may also affect domestic policies. Budget receipts in developing countries are much more heavily dependent upon the external sector than are budget receipts in developed countries. (In some cases more than 90 per cent of budget receipts originate in the external sector.) Fluctuations in exchange rates may affect the level of such receipts and, therefore, domestic policies.

Reserves in developing countries, and in some small industrial countries, constitute a much higher proportion of the monetary base than the corresponding proportion of the reserves of the main industrial countries. (In some countries with a very open economy reserves represent close to one hundred per cent of the monetary base.) Fluctuations of the exchange rates of the main intervention currencies may have destabilizing effects on developing countries by inducing variations in their international reserves and in money supply and thus, affecting their domestic policies.

The wide exchange rate fluctuation which have occurred recently may also transmit inflationary pressures to some countries. Countries with an open economy that have pegged their currencies to the dollar are particularly susceptible to the effect of the increases in prices in terms of dollars, and thus in terms of their domestic currency, generated by recent exchange movements.

The reserve and external debt of developing countries are also affected by fluctuation in the rates of reserve currencies.

FLUCTUATING CURRENCY BLOCKS AND LIQUIDITY NEEDS

The decision adopted by the main industrial countries on March 16 not only introduced a new system of floating currency blocks but also institutionalized a multicurrency system of intervention for those countries that agreed to float as a block in relation to the U.S. dollar. The decision also provided for the reactivation and extension of a vast network of swaps to finance the liquidity needs originating in the new system of intervention.

These measures affect the needs of international liquidity—of both the official and private sectors—of different groups of countries and the ways of satisfying such needs.

Floating, insofar as it improves the adjustment process reduces the liquidity needs of countries involved. Such a reduction will not, however, be distributed evenly among all sectors of the economy. Under a system of floating, stabilizing speculation will replace official intervention as a means of preventing wide fluctuation in exchange rates and to perform that function the private sector will demand therefore international liquidity. As a consequence, floating will reduce the liquidity needs of the official sector but increase those of the private sector.

A multicurrency intervention system will perhaps require greater liquidity than a single currency intervention system. Such needs are, however, very particular and will probably be satisfied by reciprocal credits. The introduction of the system has resulted in the creation of additional demands for new currencies

and has probably diminished the need for dollars. The activation of a network of swaps has in fact allowed European countries to satisfy their own needs for liquidity without regard to the liquidity needs of the rest of the world.

The liquidity needs of developing countries have increased rather than decreased as a consequence of the introduction of the new system. Instead of improving the adjustment process of developing countries, floating in blocks may tend to introduce disequilibrating forces which will result in greater needs for liquidity. The possibility of wide changes in exchange rates make it advisable for developing countries to pursue a policy of reserve diversification in order to minimize the risks involved. Furthermore, this policy of diversification will require developing countries to hold larger reserves on average than otherwise would have been necessary. In addition, developing countries have in the last few years borrowed intensively in the eurocurrency markets to alleviate their chronic scarcity of foreign exchange. Floating increases the cost of hedging and may result in a reduction of the flow of foreign exchange, supplier credits and other financial resources to developing countries.

Developing countries have progressively in the last few years financed their liquidity needs from their share in SDR allocations. SDRs permit countries to satisfy liquidity needs without transferring real resources to reserve centers. The introduction of the system of floating and blocks substantially reduced the usefulness of SDRs for developed countries since most of their incremental liquidity needs in both the private and official sectors will now take the form of a need for reserve currencies which can easily be provided through reciprocal credits. It is doubtful however that the currencies of developing countries would be accepted in exchange for the currencies of developed countries. As a consequence, developing countries will have to meet their liquidity requirements through transfer of real resources.

INTERNATIONAL SURVEILLANCE OVER FLOATING AND MULTICURRENCY INTERVENTION

The second question on which we are supposed to comment is: "What sort of guidelines should be established to regulate central bank intervention in exchange markets?" The question is extremely relevant, whatever the final status of floating in the reformed system. In my opinion the present system of floating and blocks should be subject to very strong international surveillance, perhaps even stronger than would be required under a system of adjustable parities to improve the functioning of the adjustment process. In theory, this surveillance could take two alternative forms: either to completely prohibit official intervention—a procedure which would be, in my view, both economically inadvisable and politically impossible—or to regulate the circumstances in which a country could intervene, either to stabilize the value of its currency or to achieve other purposes. In other words, the alternatives are to try to achieve a so-called "clean float" or to aim at a "regulated dirty float".

The most appropriate approach in my opinion would be to permit countries to intervene whenever they consider it necessary to do so, but to have periodic consultations between the countries involved and representatives of the whole international community (perhaps within the IMF) in order to examine the criteria and principles used for intervention. Within the context of these consultations we can even envisage the use of objective indicators to assess the adequacy of intervention policies. In a way that will not differ substantially from that proposed by the U.S. authorities in connection with the reform of the international monetary system. Variations in reserves should be one of the variables to be examined during consultation process but so should the behavior of the basic balance and other relevant variables. Unusual variations in reserves could be considered as an indication that intervention is not being used for the purpose of improving the adjustment process. Several problems could arise however during the transitional period. Floating could, as indicated earlier, reduce official needs for liquidity of the countries involved. If countries in this situation were suddenly to dispose of undesired liquidity, a problem might arise not only for the adjustment process but also for the world economy as a whole and in particular for those small countries, whose currencies, becaused pegged to the dollar, will accompany it in its decline. A possibility to be explored would be an agreement among the countries affected to hold this liquidity until the normal growth in demand for international liquidity reached the point at which it could absorb any excess of dollars—a once and for all effect—that might arise from the introduction of floating.

Parallel to the reduction in the official demand for international liquidity, floating may increase the demand of private sector for international liquidity. Clearly this demand cannot be satisfied by SDRs and will be met by increases in holdings of reserve currencies, with a corresponding transfer of real resources to reserve centers. The fantastic growth in international transactions which has occurred in the last few years, and which is expected to continue in the future, might intensify this demand for international liquidity. The possibility of sudden shifts from one asset to another may perhaps be minimized by a well functioning adjustment process but should not be discarded. The review of such a possibility should be part of a permanent process of surveillance. Measures in addition to changes in exchange rates, should be designed to minimize the impact of these shifts on domestic economies. Small countries that have pegged their rates to a main currency are particularly susceptible to the effects of such shifts.

Multicurrency intervention also requires a high degree of international surveillance to avoid the proliferation of reserve currencies. A tight settlement system, within a system of multicurrency intervention, might restrict the growth of balances in new reserve currencies, improve the adjustment process within the block and enhance the role of SDRs. All of these factors will be beneficial to the developing countries.

Most countries do not have access to the network of swaps available to the main industrial countries. The international community controls neither the liquidity created by these swaps nor their forms of settlement. I would favor international control over the use of these swaps and their settlement mechanism. One possibility would to bring them within the purview of the IMF and to regulate access to them by all Fund members (SDRs are in essence a form of swap).

SUMMARY AND CONCLUSIONS

Developing countries have expressed on many occasions their support for a reformed international monetary system based on an efficient, equitable and symmetric intervention system and the collective management of international liquidity through a strengthening in the role of SDRs (and consequently a decline in the role of reserve currencies and gold). They have also stressed that the system should ensure adequate transfers of real resources to developing countries. (Communiqué of the Ministers of the Intergovernmental Group of Twenty Four, March 24, 1973).

Floating rates might facilitate the fulfillment of some of these objectives, in particular an improvement in the process of adjustment, and could therefore be considered, from this narrow point of view, beneficial to the interests of developing countries. As I have tried to indicate, however, the present system of floating and currency blocks does not facilitate the fulfillment of the other objectives and has, in addition, adverse direct effects on developing countries. The relevant question is, therefore, whether there is any other exchange system which will help to improve the adjustment process, without having adverse effects on developing countries, and which will facilitate the achievement of the other objectives. In my opinion a system of adjustable parities, characterized by smaller and more frequent exchange rate changes and complemented by close international surveillance would satisfy these requirements. Floating may still be of some use in periods of stress.

If floating were to continue to play an important role in the reformed international monetary system, it should be subject to strict international surveillance.

Chairman REUSS. Thank you very much, Mr. Arriazu. Mr. Friedman, please proceed.

STATEMENT OF MILTON FRIEDMAN, PROFESSOR OF ECONOMICS, UNIVERSITY OF CHICAGO, CHICAGO, ILL.

Mr. FRIEDMAN. Thank you, Mr. Reuss.

I am delighted to be here. This subcommittee has had an important influence on U.S. policy and the international financial system. And that influence has been almost wholly for the good.

This subcommittee has been a force making for a greater degree of flexibility in international money markets, it has been a force restricting the degree of intervention by our central banks and Treasury

in that market. So, I can only compliment you upon the influence which you have had.

With respect to the point which Mr. Arriazu has just made, let me say at the beginning, before I go on to my own statement, that while I have long been in favor of a system of floating exchange rates for the major countries, I have never argued that that is necessarily also the best system for the developing countries. Indeed, in April of last year I gave a series of lectures in Israel which are shortly to be published in book form on the problem of monetary policies for developing countries. And in these lectures I recommended as probably the optimum policy under current conditions for a developing country that it peg its exchange rate to its major trading partner rather than have a floating system. So I believe there is no conflict between wholehearted advocacy of floating rates for major countries and the existence of currency blocs of smaller countries attached to the major countries.

Let me turn now to the main questions that you have raised.

Like the Sherlock Holmes clue of the nonbarking dog, the most important development of the past several months in the international monetary area is what did not happen. Despite unprecedented gyrations in the market for gold, despite stories day after day about a "crisis" in international money markets, there were no headlines reading, "German Reichsbank Takes in Billions of Dollars of Hot Money in Single Day," no announcements of hastily called meetings of central bankers—at pleasant places, needless to say—to do something about the international crisis, or of emergency trips by Chairman Burns and Secretary Shultz to Paris or Basle, or of carefully worded joint communiques designed to paper over agreements to disagree—all the standard accompaniments of earlier international monetary crises, that would have happened again if it had not been for the existence of floating exchange rates.

The market adjusted itself to the new international monetary arrangements far more rapidly and efficiently than the financial journalists, who continued to report as if we were operating under earlier arrangements, in particular, misinterpreting the significance of the fluctuations in the price of gold. Let me illustrate. A Wall Street Journal story early in June began, "The U.S. dollar took another tumble on international currency markets Friday." It ended, "In London, the pound rose against the dollar to $2.5820 at one point but slipped back to close around $2.5735, still well above Thursday's close of $2.5665." To translate—a change of 0.0070 in the dollar price of the pound sterling, or of one-quarter of 1 percent, is a "tumble." The story went on to blame the alleged "weakness" of the dollar for a rise in the price of gold in a single day not of one-quarter of 1 percent but of 10 times that much, 2½ percent ($3 an ounce).

Before the two-tier system was adopted in 1968, when the United States was committed to peg the price of gold on the London market, a rush into gold was equivalent to a flight from the dollar. It did require the United States to sell gold for dollars and thereby meant in the first instance a reduction in foreign dollar holdings equal dollar for dollar to the value of gold purchased. From the two-tier system to August 15, 1971, the connection was less direct but still extremely important. Persons seeking to buy gold could transfer their dollars to foreign central banks and foreign central banks could legally—though in practice they did not—demand that the United States convert the

dollar into gold. The closing of the gold window on August 15, 1971, snapped this connection and left the United States in the technical position of being unaffected either directly by the gold market or indirectly by associated flows between currencies. However, the Smithsonian agreement involving a U.S. commitment, at least tacitly, to a new structure of fixed exchange rates replaced the technical link by a political link, as was manifested most dramatically by U.S. intervention to prop up the exchange price of the dollar in August 1972.

The adoption of floating exchange rates this past February, together with the explicit refusal of Secretary Shultz and Chairman Burns to commit the United States to large-scale intervention to support the exchange price of the dollar, has finally cut the link—I trust permanently. Gold is today's soybeans, a highly speculative commodity that has recently experienced a remarkable rise in price. Someone who buys soybeans pays for them in dollars. Similarly, someone who buys gold pays for it in internationally acceptable currency—which means mostly dollars. That does not alter in any way the amount of dollars available to be held. It simply transfers them from the purchaser to the seller. If the seller prefers some other currency, he can buy that currency on the open market. He no longer has any guarantee that he can acquire it at a fixed price from the relevant central bank.

Far from demonstrating the weakness of the dollar or of the current floating exchange rate system, the recent gyrations in the price of gold have been demonstrating the weakness of gold as a monetary reserve or store of value under current conditions. Who wants to hold his liquid reserve in a form, the purchasing power of which rises or falls by 2 or 3 or 5 percent in a single day, or can double or halve in a few months? Being long on soybeans or gold may seem a good speculation when prices are going up but who would regard that, under current conditions, as a sensible way to salt away a reserve for a rainy day?

The long history of the use of gold as a monetary medium and of an officially pegged price of gold has established attitudes that will make my comparison of gold with soybeans appear strained, but, as the cultural lag disappears, and particularly after the price of gold takes a tumble or two—as it will one of these days from either its present price or an even higher interim price—the change in the role of gold will become much more widely recognized.

I do not rule out the possibility that gold may at some future time regain an important monetary role. It will do so if, and only if, governments, and the U.S. Government in particular, manage their national moneys in a highly irresponsible fashion, But for the present, gold is simply a speculative commodity with the special feature that governments own large quantities.

The past few months are a remarkable demonstration of the virtues of floating exchange rates in insulating international financial markets from speculative markets in both gold and commodities, in enabling adjustments to be gradual and orderly. The exchange rate of the dollar has on the average declined, but it has declined in an orderly fashion and by moderate amounts. There has been no sudden crisis, no closing of exchange markets, no changes of rates by 10 percent overnight. Business has been able to proceed in a far more orderly fashion than under the earlier regime. There has been none of the pressure for evermore extensive restrictions on the movement of

capital and goods that opponents of floating rates so feared. On the contrary, the pressure for such restrictions has lifted now that the market can provide a sensitive adjustment to changes in circumstances. The most dramatic example, of course, is the liberalization by Japan of its restrictions on the movement of both capital and goods.

Thus in answer to the first question your subcommittee is investigating in these hearings, the evidence to date suggests that the introduction of a floating exchange mechanism has facilitated rather than impeded international trade and investment transactions. Since I have long argued that floating rates would have this effect, I find the actual outcome reassuring but not surprising.

I turn to the second question that your subcommittee has raised, "What sort of guidelines should be established to regulate central bank intervention in exchange markets?" This question has two very different parts: What guidelines, if any, should be part of an international monetary agreement? Pending such an agreement, what policy should the United States follow? I shall restrict myself to the second question, partly because that is directly under U.S. control and in the legislative domain of this committee, partly because I believe that the answer I shall give to it is also the right answer to the first question for the United States.

In brief, I believe that the best interests of both the United States and the world financial system would be served by a U.S. policy of complete abstention from any intervention in exchange markets for the purpose of affecting exchange rates. A legislative proscription of such intervention, including the repeal of the authority under which the Federal Reserve enters into swap arrangements with foreign central banks, would be extremely desirable, both to protect the policy from the accident of changes in the particular persons in charge at the Federal Reserve or the Treasury and to give the world financial markets a firm assurance that nonintervention is the considered policy of the United States. Otherwise, there will be recurrent speculation that the United States proposes to intervene.

In testimony before this subcommittee in September 1972—and I quote from your report of last November—

> Both Under-Secretary Volcker and Chairman Burns assured the committee that, to the best of the capabilities of their respective institutions, the swap mechanism would never again be used to prop up an overvalued dollar exchange rate or delay a necessary exchange rate adjustment.

I have the greatest respect and admiration for both Under Secretary Volcker and Chairman Burns; I have every confidence in their integrity and sincerity in giving these assurances. Yet the policy that is embodied in their assurances guarantees beyond a shadow of a doubt the occurrence of precisely the opposite. The only uncertainty is the date.

They do not forswear intervention. They rather assert implicitly or explicitly that they will intervene but solely to prevent "disorderly" markets, to avoid an "undervalued" dollar, to prevent "unnecessary" exchange rate changes, not to "prop up an overvalued dollar exchange rate or delay a necessary exchange rate adjustment."

But whether a currency is overvalued or undervalued, whether an exchange rate change is necessary or unnecessary, is a matter of judgment not of objective easily determined fact. If the situation happens to be so clear as to remove any reasonable doubt, govern-

ment intervention is clearly unnecessary. In that case, private speculators will have a strong incentive to step in and correct the obviously wrong exchange rate. If the situation is not that clear, a mistake is possible. Perhaps the Federal Reserve and the Treasury will be right 9 times out of 10 or for that matter 99 times out of 100. In those cases, they will do a bit of good. But, surely, they will make some mistakes. And there's the rub. Having made a mistake, there will be a strong resistance to recognizing it, a strong tendency to hang on and hope that circumstances will change and show that it was not a mistake, a strong tendency to convert what might have been a minor exchange rate movement into a major disequilibrium and crisis. This tendency is particularly strong and particularly hard to resist when the financial risk is borne by someone else, namely the public at large, not by the officials engaged in the official speculation. That is a point which I have developed further in a Newsweek column ("Speculation and Speculation") which I have asked to be included in the record.

[The Newsweek column referred to follows:]

[From Newsweek, Apr. 23, 1973]

SPECULATION AND SPECULATION

(By Milton Friedman)

During the recent international monetary crisis, governments in all lands blamed currency speculators for their troubles. At the same time, the governments themselves engaged in currency speculation—though of course they called it by a different and more dignified name. They engaged in "intervention."

The private speculation that the governments deplored was socially useful and had desirable effects. The official speculation in which the governments engaged was socially harmful and had undesirable effects.

USEFUL

Private speculation forced governments to face up to reality, to recognize that the exchange rates they were seeking to peg were artificial. It forced Japan and Germany in particular to recognize that their currencies were undervalued. It forced them and other countries to give the market a greater role in setting exchange rates. Reality would have conquered in any event, sooner or later. Speculation made it sooner rather than later and thereby reduced the harm done by the artificial exchange rates.

Official speculation was very different. Its aim was to preserve artificial exchange rates, to postpone the recognition of reality. Had it succeeded, it would have permitted economic distortions to cumulate to still more harmful proportions.

Private speculators are far from omniscient. This time, they happened to be right and so made handsome profits. Next time, they may be wrong and suffer grievous losses. But in either case, they speculate at their own risk with their own money.

Official speculators, too, are far from omniscient. This time, they were wrong; next time, they may be right. But there is an important reason why they are more likely to be wrong than right. They speculate not with their own money but with the taxpayers' money. As a result, there is little pressure on them to control their natural impulse to resist change.

Regrettably, the U.S. participated in the official speculation. Prior to the so-called U.S. devaluation on Feb. 12, 1973, the Federal Reserve sold marks that it held and marks that it borrowed from Germany in a vain attempt to hold down the dollar price of the mark. It sold the marks for about $320 million. After the devaluation, it would have cost more than $350 million to buy back the same number of marks. The result? A negligible postponement of mark appreciation, at a cost of at least $30 million to the U.S. taxpayer and a worsening of the balance

of payments, since that $30 million also had to be financed. The U.S. taxpayer got off cheaply. Official German and Japanese speculation probably cost German and Japanese taxpayers more than $1 billion—to equally little avail.

But we have not always gotten off so cheaply. And we may not do so in the future. Official U.S. speculation before the closing of the gold window on Aug. 15, 1971, cost the American taxpayer a much larger sum. And Secretary of the Treasury George Shultz, at the end of the recent European negotiations, announced that although the U.S. was not "committed" to intervening to support the new price of the dollar, it would do so its at discretion from time to time.

As U.S. citizens, we cannot and should not prevent German and Japanese governmental officials from speculating with their taxpayers' money. That is a task for German and Japanese citizens. But we can and should restrain our own officials.

HARMFUL

It would be nice if we could simply forbid U.S. Government purchase of foreign currencies. But that is not practicable. Foreign currencies must be purchased to pay government expenses abroad. But Congress could at least forbid the purchase or sale of foreign currencies to influence exchange rates.

Moreover, the Federal Reserve speculates via so-called swap agreements under which we agree with other countries to lend them dollars on demand for a short period and they agree to lend us their currency. These swap agreements now total something like $12 billion.

The swap agreements serve no useful function and Congress should terminate the Fed's authority to enter into them. Their only role is to enable the U.S. Government to "intervene" in order to affect exchange rates. We and the world would be better off if exchange rates were determined in a free market. And whatever other countries do, the U.S., as the source of the key international money, has no business engaging in currency manipulation to affect exchange rates.

Mr. FRIEDMAN. The recent experience of Germany is a dramatic illustration—a cost of half a billion to a billion dollars imposed on the German people because of the Economic Minister's unwillingness to admit to error. Chairman Burns' description to this subcommittee of the events preceding August 15, 1971, is another only slightly less striking example. And similar examples can be multiplied manyfold, not only in the area of exchange rate intervention, but also in other areas of policy, including in particular domestic monetary policy. Almost without exception, the major mistakes in Federal Reserve policy in the nearly 6 decades of its existence reflect unwillingness to admit to mistakes and persistence in an erroneous policy until great harm has been done. With the best will in the world, that experience is likely to be repeated in the future.

The only way to prevent intervention to "prop up an overvalued dollar or delay a necessary exchange rate adjustment" is to prevent intervention, period. That will sacrifice minor advantages from slightly smoothing exchange rate movements most of the time; but it will gain the major advantage of avoiding occasional catastrophic mistakes.

The case against official intervention is strong, in my opinion, for every country—the market will do a far better job of speculation in exchange than the Government. But the case is particularly strong for the country that provides the major international currency. Whether we like it or not, the world is on a dollar standard. It will remain on a dollar standard as long as U.S. monetary policy is not more unstable and more inflationary than the monetary policy of other leading countries. As you know, I have been a strong critic of U.S. monetary policy, precisely on the ground that it has been too

erratic, shifting from unduly rapid monetary growth to unduly slow growth. I have welcomed and applauded the actions of the Joint Economic Committee in recommending a steady rate of monetary growth. Yet, defective as our policy has been, it has been less erratic, more moderate, than the policy of most other leading countries. That, plus, of course, the immense economic strength of the United States, is why the world is still on a dollar standard.

If the United States is, as in fact it is, issuing an international currency, it belies that role completely for us to intervene in the market for the currency. I believe that we should not try to force the dollar on the world. Indeed, all things considered, I believe we would be better off if some other currency had happened to become the international currency. Yet, given the situation as it is, I believe that we should not deliberately set out to destroy the usefulness of the dollar as an international currency. Central bank intervention in the market would do precisely that. The minor improvements when the Federal Reserve guesses right would be far outweighed by the harm when the Fed guesses wrong, by the controls that would be imposed to try to salvage the Fed's mistake, and even more by the widespread knowledge of the possibility of such an outcome. A firm commitment to nonintervention would reassure every holder of dollars that he could base his decisions on his judgment about objective economic circumstances and did not have to allow for the possibility of major political misjudgments.

Our own past experience shows how easily measures intended to strengthen the dollar can backfire. The interest-equalization tax, the restraint on foreign lending by U.S. banks, the restrictions on foreign investment by U.S. corporations, regulation Q ceilings on time deposit rates—all of these were undertaken to strengthen the dollar, not weaken it. Yet their combined effect was to drive the international financial market from New York to London, to encourage the rapid growth of the Eurodollar market, to make the dollar a less attractive currency to hold, to add to our balance-of-payments problems. A policy of occasional intervention into foreign exchange markets would have a similar effect.

We are a great Nation. We should act the part. We should, as soon as possible, remove all restrictions on the use of the dollar by U.S. citizens and foreigners, whether for capital transactions or for trade. We should, so far as possible, assure all that the United States will take no measures to prevent any one from holding dollars, borrowing dollars, lending dollars, spending dollars on goods and services, acquiring dollars by selling goods and services, giving dollars or receiving dollars as gifts, provided only that the terms are mutually agreeable to the parties to the transaction. That is the way and ultimately the only way to assure that the dollar is correctly valued in the market. If that policy is accompanied by a steady and moderate monetary policy at home, the dollar will remain the major international currency for the indefinite future. A "dollar crisis" will become historical curiosity.

Thank you, Mr. Friedman.

Chairman Reuss. Thank you, Mr. Friedman.

Mr. Meltzer, please proceed.

STATEMENT OF ALLAN H. MELTZER, PROFESSOR OF ECONOMICS AND SOCIAL SCIENCE, GRADUATE SCHOOL OF INDUSTRIAL ADMINISTRATION, CARNEGIE-MELLON UNIVERSITY, PITTSBURGH, PA.

Mr. MELTZER. Thank you, Mr. Chairman. It is a pleasure to be here.

I want to second Mr. Friedman in praising the influence of this committee in playing a major role in trying to eliminate the purchases and sales of dollars by the Federal Reserve and Treasury.

I am going to summarize the first part of my prepared statement and just read small parts of it.

Your letter opens two issues but requires three answers. In my opinion the answer to one of those questions is that floating rates are the best alternative currently available, and for reasons that I think are now very clear and on the record. There is at the present time no choice between fixed and floating rates. The only choice is between more orderly or less orderly adjustment of the exchange market. If we compare the crisis atmosphere that accompanied or followed the British decision to float last summer, or the 10-percent devaluation of the dollar in February 1972, with the more orderly adjustment last month and this month when the dollar was floating, we can, I think, get some idea of the advantages that we presently enjoy from the use of a floating rate.

To say that the current system is the best currently available alternative should not suggest the absence of problems. Three problems concern me.

The first and probably the most important is that exchange controls and restrictions have not been removed but have been increased. The attempt to maintain the fixed exchange rate system with the dollar overvalued and the mark and the yen undervalued led countries to place restrictions on capital movements. Trade and capital restrictions should be removed.

Second, the opportunity for crises has not entirely passed. Some countries in the EEC maintain fixed exchange rates under a complex arrangement known as the common float with the "snake in the tunnel." We have reason to expect that the rates of inflation of the countries in this group will differ. If the common float gives way easily to independent floats or adjustment of exchange rates, little harm will be done. However, if countries attempt to maintain exchange rates by restricting capital movements and trade, the world will lose. Past history suggests that the governments of some countries prefer restrictions to adjustments of exchange rates, so the danger of restrictions remains.

A third and related problem is that several countries are not only unwilling to float but unwilling to have the dollar float. They urge us to defend the currency which in their language means, purchase and sell dollars in order to protect some given rate or rate of change of rates. Giving in to these demands is a step back toward the fixed rate system with its repeated crises.

For years, practical men have told us that fixed exchange rates discourage, and floating rates encourage, speculation. Recent history suggests that the opposite is more nearly correct.

A second question asked about guidelines for floating. Those who favor guidelines for intervention argue that speculators are not always correct and often do not take a long enough view of the value of a floating currency. The central bank may hold a different view and wish to prevent appreciation or depreciation that is regarded as excessive. The opposite is also true. Central bankers are no more clairvoyant than speculators. The difference between them is more likely to turn on a different point. The speculators generally bear the cost of their own errors. The central bankers do not. The grand gesture which required the head of the central bank to resign with the announcement of devaluation has gone the way of other grand gestures. And, fortunately so. If, as I believe, the likely current alternatives to devaluation and floating are either restrictions on trade or deflation, we do not want to encourage central bankers to choose either of these latter alternatives when a choice must be made.

This committee has taken a leading role in the effort to prevent the central bank or treasury from intervening to prevent or postpone exchange rate adjustments demanded by the market. However, the statements by Under Secretary Volcker and Chairman Burns on this subject are too vague, in my judgment, to constitute a commitment. I believe the Congress should fix more definite limits and at a minimum should limit the permitted volume of swap agreements with any country and the aggregate volume of swap arrangements outstanding.

The present system of permitting interventions in the foreign exchange market wastes resources. One reason is that the Federal Reserve operates on the money market in substantial volume. Its operations there affect the covered spread between rates in New York and rates in other countries and, thereby, bring foreign as well as domestic lenders or borrowers into or out of the money market. No supplementary operations are required, a point Bagehot understood 100 years ago.

Let me urge the committee to consider the bolder step of eliminating any operations in the foreign exchange market. I urge this course not only as a means of avoiding well-documented tendency of central bankers to overregulate any market in which they operate but because the authority is redundant in a floating rate system.

There is no advantage—but considerable disadvantage—in having two separate control centers, one buying or selling domestic securities and one buying or selling foreign exchange. Both centers have their principal effects by changing the monetary base and the money stock. One center should be eliminated.

In my opinion, the United States should float without intervention in the foreign exchange market. The Federal Reserve should confine its principal activities to stabilizing the growth rate of the money stock, currency, and demand deposits. The current rate of growth should be no greater than 6 percent per year.

A third issue raised in your letter concerns longer term arrangements. I believe there is a better alternative for the future. The better alternative is the development of a uniform currency, to be used as an international money. Further, I believe, the best money for this role, is a stable U.S. dollar.

There are three main advantages of a single currency system. One is that trade expands as the costs of hedging against fluctuating exchange rates fall. A second is the elimination of costs of exchange and

conversion, including in these costs the real resources required to maintain the exchange system. The third is that exchange controls and restrictions on trade and investment become more difficult to enforce. The last is of growing importance.

A single medium of exchange reduces costs of acquiring information, hedging, and exchanging. Resources previously used for speculation, currency exchange, and hedging are released to more productive uses. The saving of resources is a real gain both to individuals and firms and to society. The labor of skilled traders operating on the Euro-currency markets is part of the saving.

The use of the dollar as an international money cannot be legislated. The choice depends on the willingness of transactors to use the dollar and to hold dollars, and, therefore, on the relative stability of dollar prices and nondollar prices. Policies that increase relative stability encourage the use of the dollar as an international money.

The Federal Reserve and the Treasury can do most to promote a stable international monetary system and the expansion of world trade by increasing the stability of the U.S. economy. More important than meetings, discussions, plans, or proposals is the obligation of the Federal Reserve to restore stability without controls on trade, prices, wages, dividends, or capital movements.

The actions of the past week are additional steps away from economic freedom and efficiency toward the inefficiencies of planning. No clearer example could be devised of the way in which one set of controls requires another and still another when regulators set out to find that nonexistent grail, the set of controls that works better than the market, in determining prices and outputs.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Meltzer follows:]

Prepared Statement of Allan H. Meltzer

Current International Monetary Arrangements

The decision in February 1972 to let the dollar float more or less freely on the exchange markets must be regarded as a decision to accept the best available alternative. Those committed to some grand scheme for the reconstruction of the monetary system and those opposed to free markets have recognized, at least for the present, that the likely alternative to fluctuating exchange rates is the proliferation of controls on capital movements and increased controls on trade and payments. Since the principal benefit claimed for fixed exchange rates by its proponents is that fixed rates encourage trade, there is not much point to restricting trade to protect fixed exchange rates. Any argument to the contrary would seem to confuse means with ends.

Much more can be said on behalf of current arrangements. Trade continues to expand. At a relatively small increase in the cost of hedging against fluctuations in exchange rates we have gained an important benefit—the improved opportunity to stabilize the economy at the current rate of inflation. Foreigners have gained as much, and some appear intent on taking this opportunity to reduce their rates of inflation. In some countries, deflationary policies are now in operation.

As long as countries pursue, or desire to pursue policies that produce, or are expected to produce, substantially different rates of inflation, there can be no choice between fixed and floating rates. The relevant choice is between more orderly or less orderly adjustment of the exchange markets. Some useful indication of the difference in the way adjustments are made under the two systems can be gained by comparing the crisis atmosphere that accompanied or followed the British decision to float last summer and the 10% devaluation of the dollar in February 1972 with the more orderly adjustment last month when the dollar declined by 7%.

SOME CURRENT PROBLEMS

To say that the current system is the best currently available alternative should not suggest the absence of problems. Three problems concern me.

The first and probably the most important is that exchange controls and restrictions have not been removed but have been increased. The attempt to maintain the fixed exchange rate system with the dollar overvalued and the mark and the yen undervalued led countries to place restrictions on capital movements. Trade and capital restrictions should be removed.

Second, the opportunity for crises has not entirely passed. Some countries in the E.E.C. maintain fixed exchange rates under a complex arrangement known as the common float with the "snake in the tunnel". We have reason to expect that the rates of inflation of the countries in this group will differ. If the common float gives way easily to independent floats or adjustment of exchange rates, little harm will be done. However, if countries attempt to maintain exchange rates by restricting capital movements and trade, the world will lose. Past history suggests that the governments of some countries prefer restrictions to adjustments of exchange rates, so the danger of restrictions remains.

A third and related problem is that several countries are not only unwilling to float but unwilling to have the dollar float. If they confine their action to accumulating dollars, they give us goods or services at bargain prices, and it is to our advantage to accept their gift. However, there are frequent demands that we intervene to maintain the exchange rate, or in the language of the central bankers, "defend" the currency. Giving in to these demands is a step back toward the fixed rate system with its repeated crises.

Those who believe that formulas can be devised under which we buy and sell currencies but on balance neither accumulate nor decumulate seem to me to miss the point to be gained from recent experience. Any formula for intervention that requires the central bank or the Treasury to defend a particular rate or rate of change improves opportunities for speculators. A fixed exchange rate is a special case of a rate that changes by less than market participants and currency speculators believe to be warranted. Attempts to maintain a rate or slow the rate of change reduce the risk to speculators and, therefore, increase speculation. In February, the Swiss floated the franc, and avoided the large inflows of dollars. The Germans "defended" the mark by absorbing many additional billions and increased the speculators' gains.

For years, practical men have told us that fixed exchange rate discourage, and floating rates encourage, speculation. Recent history suggests that the opposite is more nearly correct.

FLOAT CLEAN

Those who favor guidelines for intervention argue that speculators are not always correct and often do not take a long enough view of the value of a floating currency. The central bank may hold a different view and wish to prevent appreciation or depreciation that is regarded as excessive. The opposite is also true. Central bankers are no more clairvoyant than speculators. The difference between them is more likely to turn on a different point. The speculators generally bear the cost of their own errors. The central bankers do not. The grand gesture which required the head of the central bank to resign with the announcement of devaluation has gone the way of other grand gestures. And, fortunately so. If, as I believe, the likely current alternatives to devaluation and floating are either restrictions on trade or deflation, we do not want to encourage central bankers to choose either of these latter alternatives when a choice must be made.

This Committee has taken a leading role in the effort to prevent the central bank or treasury from intervening to prevent or postpone exchange rate adjustments demanded by the market. However, the statements by Under Secretary Volcker and Chairman Burns on this subject are too vague, in my judgement, to constitute a commitment. I believe the Congress should fix more definite limits and at a minimum should limit the permitted volume of swap agreements with any country and the aggregare volume of swap arrangements outstanding.

The present system of permitting interventions in the foreign exchange market wastes resources. One reason is that the Federal Reserve operates on the money market in substantial volume. Its operations there affect the covered spread between rates in New York and rates in other countries and, thereby, bring foreign as well as domestic lenders or borrowers into or out of the money market. No supplementary operations are required, a point Bagehot understood 100 years ago.

The existence of two centers of operations opens the prospect that one will buy as the other sells. This is not likely to occur in a direct exchange but it is no less a waste of resources if it occurs via third parties.

Let me urge the Committee to consider the bolder step of eliminating any operations in the foreign exchange market. I urge this course not only as a means of avoiding well documented tendency of central bankers to over regulate any market in which they operate but because the authority is redundant in a floating rate system.

Most importantly, a principal advantage of a floating exchange rate is that the central bank is free to pursue domestic objectives, full use of resources and price stability or a steady rate of inflation. Floating rates increase a central bank's ability to control the growth rate of the money stock. There is no advantage—but considerable disadvantage—in having two separate control centers, one buying or selling domestic securities and one buying or sellign foreign exchange. Both centers have their principal effects by changing the monetary base and the money stock. One center should be eliminated.

In my opinion, the United States should float without intervention in the foreign exchange market. The Federal Reserve should confine its principal activities to stabilizing the growth rate of the money stock, currency and demand deposits The current rate of growth should be no greater than 6% per year.

LONGER-TERM ARRANGEMENTS

Although I regard floating exchange rates as the best currently available alternative for the United States and the world, I believe there is a better alternative for the future. The better alternative is the development of a uniform currency, to be used as an international money. Further, I believe, the best money for this role, is a stable U.S. dollar.

There are three main advantages of a single currency system. One is that trade expands as the costs of hedging against fluctuating exchange rates falls. A second is the elimination of costs of exchange and conversion, including in these costs the real resources required to maintain the exchange system. The third is that exchange controls and restrictions on trade and investment becomes more difficult to enforce. The last is of growing importance.

A single medium of exchange reduces costs of acquiring information, hedging and exchanging. Resources previously used for speculation, currency exchange and hedging are released to more productive uses. The saving of resources is a real gain both to individuals and firms and to society. The labor of skilled traders operating on the Euro-currency markets are part of the saving.[1]

Similar savings are not available in a system of fixed exchange rates if there is more than one currency. The reason is that there are costs of conversion and exchange and costs of obtaining information about future exchange rates and exchange opportunities. Resources used for speculation and exchange receive positive net returns, so individuals are induced to allocate time and effort to these activities. A dual currency system, for example a European currency and the dollar, does not eliminate costs of exchange or costs of acquiring information about price levels and anticipated rates of inflation in the two areas. As long as rates of inflation differ, or are anticipated to differ in the two areas, resources will be allocated to exchange operations.

The gains from using a single currency are largest if the currency is well-known and familiar and can be produced at relatively low cost. The two assets that are best known as money and have been widely used as money are gold and dollars. The costs of production for the two are very different. Society gains much more if the dollar is used as the international medium of exchange because cost of production is much lower for dollars than for gold.

The use of the dollar as an international money cannot be legislated. The choice depends on the willingness of transactors to use the dollar and to hold dollars and, therefore, on the relative stability of dollar prices and non-dollar prices. Policies that increase relative stability encourage the use of the dollar as an international money. A policy of maintaining relatively stable growth of the money stock benefits the U.S. and the world economy. Transactors continue to hold dollars and to use dollars.

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[1] I have developed this argument in more detail in "The Dollar as an International Money", *Banca Nazionale del Lavoro Quarterly Review*, March 1973, pp. 21–8. See also Charles P. Kindelberger, "The Benefits of International Money", *Journal of International Economics*, September 1972, pp. 425–42.

A more thorough treatment of the issues is in K. Brunner and A. H. Meltzer, "The Uses of Money: Money in the Theory of an Exchange Economy", *Amer. Econ. Review*, Dec. 1971.

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During the postwar years we have observed the rapid growth of the Euro-dollar market and the increased use of the dollar as the medium of exchange in international trade. Tourists have found that checks drawn on U.S. banks are accepted in foreign countries. In many parts of Canada, the U.S. dollar is known and accepted in exchange by merchants and shopkeepers. Despite the variability of the exchange rate and the U.S. price level in recent years, the dollar has continued to be the principal money used for international transactions.

Once again, the reason is that costs of learning about a new currency and its properties as a medium of exchange are large. Transactors have shown themselves willing to pay the increased costs resulting from the instability of the dollar rather than incur the costs of shifting to an alternative money. If we can avoid trade restrictions and restore stability to the domestic price level I believe the role of the dollar will increase. The increased role will result from the decisions of private transactors seeking to reduce costs, not from the actions of central bankers or international agencies or their decision to restore fixed exchange rates.

The Federal Reserve and the Treasury can do most to promote a stable international monetary system and the expansion of world trade by increasing the stability of the U.S. economy. More important than meetings, discussions, plans or proposals is the obligation of the Federal Reserve to restore stability without controls on trade, prices, wages, dividends or capital movements.

The actions of the past week are additional steps away from economic freedom and efficiency toward the inefficiencies of planning. No clearer example could be devised of the way in which one set of controls requires another and still another when regulators set out to find that non-existent grail, the set of controls that works better than the market in determining prices and outputs.

Chairman REUSS. Thank you, Mr. Meltzer.

To concentrate first on this question of the different position of the less-developed countries, Mr. Friedman, in your statement you say: "The case against official intervention is strong in my opinion for every country—the market will do a far better job of speculation in exchange than the government."

I would be helped if you could explain your Israel lecture. That is to say, how does a less-developed country tie to a major currency for which it has an affinity without intervention?

Mr. FRIEDMAN. The best and most effective way is to use that currency. Panama is a good case in point. It uses the American dollar. No official intervention is necessary. That is to say, what you want is a unified currency—and this goes very much along of what Professor Meltzer was saying—the ideal, I would think, would be a strictly unified currency. That is essentially what the United States did in the 19th century. We essentially used, along with Britain, a single currency, namely gold. We gave it the name dollar, and they gave it the name sterling, but essentially it was a single money.

The next best thing, if a country is going to insist on having a currency with its own name is to do what Hong Kong for example did for many years. It issues a Hong Kong dollar. Of course that Hong Kong dollar was rigidly linked to the pound sterling in the sense that anybody could get Hong Kong dollars at a fixed rate with respect to sterling, or anybody could get sterling for Hong Kong dollars by turning in the dollars. And in fact the Hong Kong Currency Board maintained a 100-percent reserve for its currency in terms of sterling. So essentially the alternative to a developing country is to avoid speculation by having essentially the currency of a large trading partner for its currency. It may if it wishes for national pride, and so on, give it another name and call it an Argentina peso instead of a U.S. dollar, or an Israel pound instead of a British pound.

Chairman REUSS. Let me now turn to Mr. Arriazu.

To what extent does Mr. Friedman's explanation reduce the swelling on the part of the less-developed countries?

Mr. ARRIAZU. I would say not to a very large extent, Mr. Reuss. I would very much agree with him that if we could have an international currency, one currency for the whole world, this would be a very ideal situation. But I would very much hope that this is not the national currency of one country, but an international currency managed by international authorities.

Chairman REUSS. Would your objection to Mr. Friedman's solution be that it involves a master-slave relationship?

Mr. ARRIAZU. More than that, Mr. Chairman. The point is that even though we could use, let's say, one currency which is not our own to manage our domestic affairs, the problem that we would have there is that we would not have the same degree of freedom that we have now internally. It is not only a political question but also an economic question related to changes in the amount of money domestically.

And the third point that I will stress here is that if we are tied to one currency and used this currency as our main intervention and domestic money, then we would actually be having an adjustment process which is very similar to the gold standard where domestic deflation and inflation would be the adjustment processes of the system. So beside the political reason, I wouldn't favor this solution on economic grounds.

Thank you.

Mr. FRIEDMAN. May I comment to the effect that what Mr. Arriazu has pointed out as disadvantages are really advantages. The whole reason why it is an advantage for a developing country to tie to a major country is that historically speaking the internal policies of developing countries have been very bad. U.S. policy has been bad, but their policies have been far worse. There are no gyrations in American monetary policy which can hold a candle to the gyrations which have occurred in Argentinian domestic monetary policy. So the whole reason why tying to a major currency would be an advantage to Argentina is that precisely that it would prevent them from following bad domestic monetary policies. They would have less of an adjustment problem simply because our policy will prove to be more stable than theirs.

As to the first point, Heaven forbid an international, unified currency which is managed by an international central bank. A domestic central bank subject to domestic political considerations has proved to be capable of doing enormous harm. An international central bank, subject to no effective political controls, could do far worse harm—of course it wouldn't really, because there is no major country in the world that would in fact stick with an international central bank dominating its country if it did not approve of the actions it was taking.

So that I think the possibility of an international managed currency—fortunately from my point of view—is very small.

I think there is all the difference in the world between countries accepting the same currency, gold, as they did in the 19th century, not subject to management by some group of people, but limited in supply by physical circumstances, and their accepting an internationally politically managed currency.

Chairman REUSS. I would just interject, before calling on Mr. Meltzer, that I feel there is something a little elitist about the big countries telling the less-developed countries that they want to help protect the less-developed countries from themselves. In Brazil, for instance, after the Army marched in and took over the Government,

displayed a sounder domestic monetary policy, and has reduced inflation from whatever it was to about only 20 percent a year.

The police state aspects which came along with that, yes——

Mr. FRIEDMAN. But I am not arguing at all that the big country should put pressure on the developing country. This is advice to the developing country. It is their business. It is not our business particularly, it doesn't make a bit of difference to the United States what Argentina does with its currency with respect to the dollar. I am not saying that the United States should impose any pressure on Argentina to do it whatsoever.

Chairman REUSS. You say, give a smaller country, country "X," a really small one, this choice. But suppese for these political, psychological historical reasons they say, we don't want to come under——

Mr. FRIEDMAN. Then they should completely float.

Chairman REUSS. And then what kind of a position does that put them in? How many of Mr. Arriazu's difficulties and objections are answerable?

Mr. FRIEDMAN. They need no reserves if they float freely. They have no adjustment problem. The only difficulty it puts them into is that they will have a bad internal monetary policy. They will have freedom in this internal monetary policy, but you can predict without fear of successful contradiction that for almost every country it will be a bad one.

Chairman REUSS. Mr. Meltzer.

Mr. MELTZER. I am not quite as pessimistic as Mr. Friedman, but I think the main issue here is that the best alternative available to countries at the present time, and I think for the foreseeable future, is to move gradually and voluntarily toward a single currency. I believe there are two main alternatives, gold and the dollar, and the dollar is by far the better alternative. I see no role for the SDR in any system of that kind, mainly because the SDR does not have the properties of money and is unlikely to acquire the properties of an international money. The dellar possesses those properties, and it will be far cheaper for the world, if it is going to go toward a single currency system, to move to the dollar system.

I want to emphasize that that system has to be a voluntary system. Each country can make a choice. And the choice that they are going to make is essentially the one that you laid out a moment ago, whether they want to pay the costs of having internal instability as a result of changes in the exchange rate for their country, that is, different international prices for their exports and imports at different times, or whether they want to pay the cost of pegging themselves to a foreign currency. These are their real choices, and different countries will at different stages in their development make different choices. But if the United States proceeds toward stability, then it seems to me that the choices will become very clear, and relatively quickly. It is noteworthy that the dollar system has held up despite the instability resulting from our policies.

Chairman REUSS. Would you like to comment on the comments?

Mr. ARRIAZU. Mr. Friedman has expressed very clearly his opinion that the domestic policies of developing countries have been much worse than the policies of developed countries. I would not like to contest that opinion. I will say that in some circumstances they have

been. But on the other hand, I would like to say that on many occasions they are the result of political necessities. The advances in the means of communication has induced in our countries, as it appears on many occasions, aspirations to a higher standard of living, comparable to that of developed countries, and the consequences have been political. The authorities of developing countries have not been able to say no to these demands and on many occasions monetary policies, for example, have had to follow these decisions, made at the political level. I do not think we can call them bad policies just on economic grounds. Wisdom is not the property of developed countries.

The second thing I would like to say is that while it is true that theoretically in a system of floating you would not require official holdings of liquidity, the system is in fact transferring the needs of liquidity from the official to the private sector. In addition, I believe that even in this case the authorities of developing countries will continue to keep reserves in order to protect their economies against the failure of crops, or some other type of circumstances. The transfer of real resources from developing countries to reserve centers, involved in the process of reserve accumulation will therefore continue for developing countries even with floating.

Chairman REUSS. Both Mr. Meltzer and Mr. Friedman say intervention? Never! Neither of you say intervention hardly ever. I do think, to use the example I occasionally cite, that if you have floating exchange rates and a head of state is assassinated, then there is a big run on your currency, at least temporarily, wouldn't you be tempted, as the money manager, to help out a little bit?

Mr. FRIEDMAN. On the contrary—let me give you a realistic example, if I may, which is not quite the assassination.

I was interested in having this argument thrown at me in Israel. Now they say, if we have a 7-day war break out, or the threat of war, should we not step in to protect the Israeli pound?

And my answer was exactly the opposite. Let us suppose that there is a threat of war to Israel. Who tries to get rid of Israeli pounds? The people who have little confidence in Israel. Who is willing to buy Israeli pounds and get rid of dollars? People who have much confidence in Israel. What is the effect of letting the exchange rate go? People who have little confidence in Israel will lose money and people who have much confidence in Israel will make money. Is that bad?

In the same way, let us take an assassination of a head of state. You are talking about a very short-term effect. Nobody in a few days is going to be able to take physical goods and get them out of the country. Nobody in the Israeli case was able to get physical goods out of Israel. The only way that people can get their capital out of the country is by persuading somebody else to buy. Only those who have little faith in your country's future because of the assassination will try to sell their property in the country. And those people who have much faith will buy it. It seems to me on the whole that that is a very desirable transfer, and we ought to encourage it, not discourage it.

Moreover, so far as the effects on trade are concerned, those effects will not occur, unless this temporary emergency, this immediate crisis, becomes long extended, and lasts for some time. A short bubble in the currency is not going to have much effect on trade patterns.

So I would say, not only never, but the case you cite is a particularly strong case for avoiding intervention.

Chairman REUSS. Get the country in friendly hands.

Mr. FRIEDMAN. That is right, absolutely.

Mr. MELTZER. Let me add to that. If the crisis is prolonged then, of course, you want the exchange rate to move. You do not want to prevent it from moving. If there is a prolonged crisis you want the rate to move. So the real point, I think, in this is that an advantage we now have is, we are now free of foreigners telling us that because they insist upon maintaining a system of fixed exchange rates, we should not pursue the domestic stabilization objectives that we should in fact pursue. We now have freedom to intervene in the money market to maintain the appropriate rate of money supply growth. And that is what we should be doing.

Chairman REUSS. Both Mr. Friedman and Mr. Meltzer, in discussing our domestic economy, have as before stressed the importance of a steady and moderate rate of increase in the money supply as one desirable feature of a sensible overall policy. Looking at the last 18 months, that is, all of 1972, and the first 6 of 1973, what kind of marks would you give our friends—and they are our friends—at the Fed?

Mr. FRIEDMAN. I am completely unprejudiced. Some of my best friends are at the Fed. And that is a literal statement. But unfortunately, I have to give them low marks. I believe the rate of growth of the money supply over the past 18 months has been decidedly too high. I believe it must bear a great deal of responsibility for an economic climate which underlies the rapid price explosion in the first few months of this year.

I have stated that rather carefully for the following reason. The inflation which we had in the first 4 months of this year is larger than can be explained in any mechanical way by the rate of monetary growth last year. That rate of monetary growth was too high. But looking at the quantitative relationship, it was not high enough by itself to have produced a 14-or 15-percent rate of growth in GNP in the first quarter. It was too high, but not that much too high.

However, the fact that you have had for 18 months a steady and very high rate of monetary growth created a climate which made it very easy for inflationary expectations to develop, which made it easy to add a tremendous explosion on top of too rapid a monetary growth.

And so I would say that this country would be in far better shape today if over the past 18 months the broader monetary aggregate, M–2, currency plus net time deposits, had grown at a rate of something like 7 percent per year instead of at a rate of over 10 percent; if the narrower aggregate M–1 had grown at a rate of something like 4 percent a year instead of something like the rate of 8 percent per year.

Chairman REUSS. Looking back at what happened, after creating new money, narrowly defined as M–1, at the rate of 8 or 9 percent during 1972, the Fed apparently recoiled in early 1973. But then, for some reason not known to me, the rate of increase bounced back, I believe, rather sharply in mid-April and May of this year and came out at either 8 percent or so.

Mr. Meltzer.

Mr. MELTZER. I want to put in a caveat, because the Fed has been achieving approximately the same rate of expansion throughout. What has made it different has been some movement of the Treasury balances, particularly during the winter. The Treasury has taken the opportunity to sell bonds or sell bills and fund its deficit abroad, and has locked the proceeds up in the commercial banks or the Federal Reserve banks. Now, those funds are being paid out. These are minor technical details, but they have persisted for a longer time in time than they normally do. These and other technical details have made the growth of money supply appear to be lower than it otherwise would have been. But it is now back on the trend line, I think, at about 7 percent for M-1, narrowly defined money. The technical problems producing variability should not concern us. What is of concern is that last year we had an 8 percent rate of growth. And at the moment we have what I believe confidently will be at least a 7 percent rate of growth in narrowly defined money by the end of the quarter. The technical problem will be erased. So I believe the Fed has been too expansive throughout this period.

I would caution, however, that there are dangers in too fast a deceleration. I would like to see the Federal Reserve proceed—I would like to see the inflation worked out of the system—but I would like to see us proceed to a stabilizing policy gradually. The fear that I have is that we will repeat the errors that we have had now three or four or five times in the last decade.

We will get very concerned about the inflation problem; we will try to do something to correct inflation; we will push down very hard on the money supply; we will get the consequences of unemployment that follow such a policy; and we will then proceed to do something about the unemployment problem, neglecting our worries about inflation. Rapid deceleration, or movement to a negative growth rate of money seems to me to have left us with heritage that is much worse each time we go through it. It would be far better, it seems to me, to pay the costs and try to gradually rid the system of inflation this time rather than to try to remove inflation because of our current concern.

Chairman REUSS. The new money supply, M-1, went down to about zero for the first 2 or 3 months of this year. Is that some kind of a statistical aberration or was that too fast a decline?

Mr. MELTZER. It was largely what I would describe as a statistical aberration having to do mainly with the Treasury movement of its balances. It actually did not get down to zero. If you take the St. Louis Federal Reserve Bank measure, money growth is now reported to have been about 4.7 percent for the first quarter. It will be substantially higher than that in the second quarter, and will average at least 7 percent for the first half year.

Mr. FRIEDMAN. I do not really disagree with what Professor Meltzer has been saying, but I would add a different gloss to it. I agree with Mr. Reuss that the Fed was appalled at what happened in December of 1972. They did not intend the money supply to rise by as much as it did. They tried to back away from it. They did back away from it. In fact, they were assisted in backing away from it by the events that Professor Meltzer described, the fact that the Treasury accumulated balances. And now again, I think that the Fed is appalled by what has been happening in the past month or two. And I think the

main lesson to be drawn from all this is twofold. The first is the desirability of having a lower goal for monetary growth. And I think the Fed has been aiming at too high a goal. It has been aiming at something like 6 to 7 percent, and it has ended up getting something like 8 percent. It should be aiming at a lower goal.

Second, it is long past time that the Fed did something effective about improving first its statistics, and second, its operating methods, so that it can be more assured of achieving the growth rates that it aims at. I think it is literally disgraceful that our monetary statistics, should be so defective that the Federal Reserve should have spent enormous sums of money on improving statistics on industrial production and all sorts of statistics and we still cannot get decent statistics on the money supply. I think there is no excuse for that whatsoever.

Chairman REUSS. Suppose you two gentlemen had been Secretary of the Treasury and Chairman of the Federal Reserve Board in the first 6 months of 1973. I do not care which occupies which office. What do you think you would have been able to do by way of M–1 in that period? Would it have been a famine and then feast, or would the money supply have grown more smoothly—what I am trying to get at is, how inevitable, how much written in the stars was this Treasury transaction which then caused things to go apparently out of control during May?

Mr. FRIEDMAN. It was not written in the stars at all. There was no necessity for it at all. The Fed is in a perfectly good position to offset the Treasury operation, there is nothing easier for it.

Chairman REUSS. And the correction could have been applied at the very period that the Treasury was doing its performing?

Mr. MELTZER. On a weekly basis. But I do not insist that they have standards of that kind.

Mr. FRIEDMAN. They should operate on a weekly basis. You cannot get a perfectly steady growth on a weekly basis, but you can come very close on a month-to-month basis, and even closer on a quarter-to-quarter basis. There is no excuse for the wide fluctuations that have in fact occurred. There is no technical necessity for it. The Fed has every tool that it needs to be able to keep the quantity of money growing steadily. The reason for those wide fluctuations in monetary growth has not been the absence of either tools or knowledge, it has been because of the continued tendency of the Fed to try to ride two horses at once, that is to say, to try to intervene in the market for credit to affect interest rates, at the same time that it is trying to control the movements of the monetary aggregate.

Chairman REUSS. I have not checked what the rate of increase in the money supply has been so far this year. But considering 3 months of famine and 2 months of glut, it probably works out at something reasonably sensible, say 4 or 5 percent.

Mr. MELTZER. Seven, at least seven by the end of June at annual rates.

Chairman REUSS. Is that so?

Mr. FRIEDMAN. And it will unfortunately, I am afraid, go higher. One of the effects, I am afraid, of the President's freezing of prices in phase 3½, as it has been called—and I join Professor Meltzer wholly in deploring that measure—one of the effects is likely to be a faster rate of monetary growth, because it tends to remove the pressure on

the Fed. After all, if prices are now frozen, the Fed can turn its attention to seeing that interest rates do not go up, and it does not have to put as much emphasis on trying to prevent inflation. So I fear that we are headed for a higher rate of monetary expansion, not a lower one.

Chairman REUSS. One more question on this subject. Beyond the fact that the Fed's rate of new money creation this year, 1973, appears averaged out to have been, too much, without saying how much too much, apart from that, suppose it were not 7 percent, but an average of 4 percent. What disadvantages would there have been in its having been as uneven as it has been? Does it matter very much, if you starve people a little bit in January, February, and March and then gorge them in April and May?

Mr. FRIEDMAN. That is a very good question. And there is no really satisfactory answer. Because obviously, I am sure both Professor Meltzer and I would agree that if it was fast one week and slow the second week there would be no difference, or if it is 2 weeks versus two weeks. On the other hand, if it is 6 months versus 6 months, that makes a difference. Exactly where the line is drawn is very hard to judge. I may say that I have done a good deal of empirical work in trying to give a more precise answer to your question. And all I can say at the moment is that it is perfectly clear that if the fluctuations are of a duration longer than one quarter, if they are 3 or 4 months, they are reflected in a corresponding unevenness in economic activity. But I have not been able to pin down any narrow dividing point. As to whether month-to-month fluctuations are important or not, probably not. It makes very little difference. But if you go longer, let us say 3 to 6 months, or 6 to 6 months, then the harm it does is that it causes people to react to false signals. You get the signal that the economy is going to slow down, and so you adjust yourself directly or indirectly to that. I do not mean you get the signal necessarily by looking at the number, but you get the signal by what happens to your cash balances, and then some reverse signals 3 months from now. And so it is as if you are forced to expend a lot of your energy in adjusting back and forth in a wholly unnecessary way. This shows up, of course, in a greater instability in interest rates than would otherwise occur. That is one of the paradoxes of the situation, that the Fed's concern with stabilizing interest rates has produced a more unstable pattern of interest rates than would have occurred if they had forgotten about interest rates and only looked at the quantity of money.

Mr. MELTZER. I agree almost completely with what Professor Friedman says. I would only add this. Somewhere between a quarter and two quarters there is a dividing line at which it becomes important what the variation is. A variation from 8 to 4 percent in your example, that is, 8 percent last year to 4 percent this half year, would be the same in an economy that had lower rates of inflation than ours, as a variation from 4 percent to 0. Now, he would expect that policy, if maintained, to reduce output. It was a variation from 6 percent to 0 that gave us the minirecession of 1966. A monetary contraction from 6 percent to 0 maintained over a very short period of time produced a minirecession. A reduction of 4 percent to 0, or 8 to 4 percent, would be likely to have a similar effect.

I would not want to see the growth rate reduced too rapidly. If I were in the office that you gave me a few moments ago, I would be trying to slow the rate of money growth down from 8 percent, aiming, to reduce the rate of inflation gradually over the period of the next 2 years.

Mr. FRIEDMAN. I may say that I believe that the unduly high rate of average growth has been a more serious defect of Federal policy over the past year and a half, the period you are referring to, than the unevenness. I think the unevenness has been bad. But if you say which is the more important, I would say it is the high average level.

Chairman REUSS. You gentlemen have just mentioned the administration's economic program of last week. I am going to state it is three main facets and ask for your comment. Facet 1, you have already commented on, that is, the 60-day across-the-board price freeze. Do you applaud or deplore it?

I think you deplore, Mr. Friedman.

Mr. FRIEDMAN. Yes, indeed.

Chairman REUSS. Facet 2, the absence of any change in fiscal policy.

Do you applaud or deplore?

Mr. MELTZER. I believe the fiscal position is coming into a reasonable balance at this time. The budget for the first time in several years is coming into balance. I think it would be far better if the budget were to be balanced at a lower level.

Mr. FRIEDMAN. On fiscal policy, I deplore the absence of further reductions in spending. But I approve the absence of any suggestions for higher taxes. While from a stabilization point of view higher taxes with constant spending and lower spending with consistant taxes if one occurs are equivalent, from a long run or political point of view they are not equivalent. I believe the main basic effect of higher taxes tends to be higher spending, not a lower deficit. I believe that the only way to get taxes down is to get spending down. Therefore, I believe that the basic effect of lower spending is lower taxes. From this point of view, I believe that you could promote both a short-term stabilization objective and the long-term objective by being in favor of lower spending, whereas you would promote one, but harm the other if you were to come out in favor of higher taxes. As a result, I deplore the absence of a recommendation for a sharp reduction in spending.

Chairman REUSS. Well, we cannot agree on everything.

The third facet of the program, on which I would ask your comment, is the request to Congress for authority to end or curtail exports of any commodity when the President determines that such action will improve price stability.

Mr. MELTZER. I not only deplore the request, I hope that Congress will refuse to grant it. I notice that the House Committee yesterday at least, took some steps in that direction. And I think they are to be applauded. I hope that the House as a whole and the Senate, will take further steps to refuse the President that authority.

Mr. FRIEDMAN. I think that is a very complicated question. Obviously, I deplore export controls in the sense that I am and always have been a believer in free trade. But if you have a freeze, if you have a phase IV which consists of stringent price controls, then there is no way of avoiding export controls. Those who say A must say B.

Chairman REUSS. Of course, the President said that he is not going to stand idly by while Mrs. Jones' hamburger and eggs disappear from her table. But, of course, you can prevent that by export controls, domestic allocations and rationing, or some combination of both.

Mr. FRIEDMAN. They are equivalents. If you have domestic allocation you are saying that the amount that is allocated cannot be exported.

Chairman REUSS. They both depart——

Mr. FRIEDMAN. More than that, domestic allocations are export controls. It is just a question of wording, whether I say that a certain amount must go into domestic supply, or if I say that a certain amount may not go for export.

Chairman REUSS. Any President wishing to be a one-term hero could provide that any diminution of the meat and eggs on Mrs. Jones' table by reason of export demand, at whatever the ceiling price was, would be tolerated, and that the remainder, the domestic remainder, would be subject to allocation.

Mr. FRIEDMAN. I misunderstood you. You are quite right. But entirely aside from a one-term President, if you are asking, would that reduce or increase the harm which is done by the controls, that policy would increase the harm. I am opposed to the freeze. I am opposed to the controls precisely because a logical consequence of those controls is that you must have allocations. And if you must have allocation, export controls are a part of that allocation. What you and I are now talking about is only what the level of the permitted exports is to be. We are not really arguing about whether there should be export controls or not. You are saying that it would be possible for the President to be generous in the export allowance and ungenerous in the domestic allowance or vice versa. The tragedy of the present situation is that we are drifting into a policy that nobody wants, because of a failure on the part of the public at large to recognize that effective price and wage controls imply rationing, allocation, and export controls. They think they can have their cake and eat it, too, but they cannot.

Mr. MELTZER. Let me take issue, at least slightly, with Professor Friedman.

I would prefer to see you, if you must, put on the freeze and not the allocation scheme for the following reason. I agree that without the allocation scheme the freeze will fail. And I say, let it. I think that there is no doubt in most people's mind about why the President recommended the controls, or why so many Congressmen have wanted controls, because the public has been pressuring their Congressmen and the White House to do something about the inflation, and particularly to do something of this type.

The hard question to answer is, why does the public want a policy that has failed in so many places and at many different times. I think the important thing to be done at the present time is to let them have the policy if that is what they want. Let them have the policy and let them find out that policies of that kind are not a substitute for the kind of policies that we have to use to control inflation. So I would prefer to see the 60-day freeze if we must have it, but without the allocations.

Mr. FRIEDMAN. This is a question—and I do not really think we should discuss it here—it is a question of politics.

I want to comment on one point that Mr. Meltzer raised. Why is it that we are having this policy, why is it that the Congress and the

President are giving us this policy? And I do not believe the answer is quite the one that Professor Meltzer gave. The answer is because we want inflation, the Congress wants inflation, the President wants inflation, the public wants inflation. At the same time the public and the Congress and the President want to be able to pretend that they do not want inflation, they want to be able to pretend that they are doing something about inflation. In every country in the world the reason you have had price and wage controls and freezes is so that you can have the appearance of doing something about inflation when you really are not doing anything about it. Price and wage controls have nothing to do with inflation. They have no more to do with inflation fundamentally than, as my former chancellor used to say, football has to do with a college education. What they are, are window dressing.

The trouble is, you start out with window dressing and you end up with a whole host of other allocations that make the whole thing a mess. And finally, the whole bubble bursts. Finally, you discover that really you have done more harm by trying to pretend you have done something about inflation than by letting inflation go. That is what happens.

People have such short memories. People do not remember World War II. We had exactly this kind of a price and wage allocation system. We had 50,000 full-time employees in the Office of Price Administration and 250,000 part-time assistants. The result was the creation of a black market and evasion. That is what you are going to have again. What is going to save this country from the worst consequences of the move toward controls is the unrivaled genius of the American public in finding ways around laws it does not approve of. That saved us from prohibition, and it will save us from this.

Chairman Reuss. Before we leave the OPA, which both President Nixon and I served on with distinction, let me point out that there was a good deal of black-marketing and law violations, but that almost none of the 50,000 employees was ever found taking a dime, which is really quite a remarkable record of public service. I think not only were they not found stealing, but I think they, in fact, did not steal.

Mr. Friedman. I am sure that is true, Mr. Reuss. But you know one of the worst things about the price control arrangements, one of the really worst things, not from an economic point of view, but from a much more fundamental point of view of the texture of society, is that it converts private vice into public virtues. The sad fact of the matter is that those wartime price controls would have done less harm if the people administering them had been more corrupt. That is a terrible thing to have to say, but it is the God's honest truth. I am reminded of a comment that a former statistics teacher of mine, Harold Hotelling, once made: "Pedagogical ability is a vice, not a virtue, if it is devoted to teaching error." Unfortunately, integrity and incorruptability becomes a public vice, though it remains a private virtue, if it is devoted to enforcing bad laws. That is one of the worst things really, about controls that people do not take into account. Price and wage control forces people to be lawbreakers. They are going to be driven to it, because the pressures are going to be enormous.

More important, the people who break the law will benefit at the expense of people who do not. The man who is honest and does not

violate the price ceilings, in spirit or letter, is going to get the short end of the stick. The man who does violate the ceilings is going to be benefited and so also is the country, because if prices do not ration, something else must ration, and better indirect prices than rationing by pure chance. The consequence, therefore, is that price controls, the associated rationing, and allocation undermine the moral basis of our society. We saw that on a very large scale with prohibition. Surely a major cost of prohibition was what it did to the respect for the law and to the willingness of people to break the law. That is where we are headed again.

Fundamentally, my major objection to the price control, wage control, and rationing is much less with respect to its direct economic effect, than with respect to its indirect effect on the morale and ethical structure of our society.

Chairman REUSS. Do you really believe that the OPA experience in World War II caused a marked deterioration of the moral stature of American society?

Mr. FRIEDMAN. The OPA experience in World War II did not cause a marked deterioration. It did not cause a marked deterioration because you were in the course of a major war which had widespread public support for it, because many of the problems arose from the simple nonavailability of goods. You had no production of automobiles. But it did cause some deterioration in the moral structure. I can remember, and you can remember, the people who were trafficking in red meat stamps, the people who were getting meat from under the counter from their butchers, the people who were getting cigarettes at above ceiling prices by virtue of buying something else. There were many, many cases, as you and I can remember from that time, of widespread violation of the letter and the spirit of the law. Had it lasted another few years, especially had it lasted after the war, the effects would have been far worse. During a major war, which the public at large is strongly in support of, the climate of opinion is very different than you have now. Now is an especially bad time to impose controls, because unfortunately, the moral climate has already suffered very greatly from the divisiveness over the Vietnam issue in the past 10 years, and it suffered from the Watergate affair. At such a time it seems to me the dangers of still further undermining the moral climate are greater than they were in 1943.

Chairman REUSS. Let me now turn to a point made by Mr. Meltzer in his discussion of longer term arrangements. When you spoke of the possibility and desirability of making the dollar once again the major reserve currency, how would you do that without taking care of the large-scale dollar overhang?

Mr. MELTZER. The way I would do it would be to do it voluntarily. I think that main emphasis has to be placed on voluntary arrangements. I would restore stability to the domestic economy, as I say in my statement. Once stability is restored to the domestic economy, holders of dollars are going to have a choice. And the choice they are going to have is to buy American goods or buy assets of American firms. They can invest in stock exchange assets and land, buy corporations, or make whichever portfolio investments in assets of American corporations they choose. Once the restrictions that have been imposed by the U.S. Government to encourage people to hold dollars are re-

moved, all dollars will be willingly held. Most of the dollars in the world are willingly held at this particular point. There are some that are still locked up in central bank balances that, I believe, some central banks would reduce if they were given a freer choice. But most of the dollars that are outstanding in the world are willingly held.

Second, I would take one other step which is not part of the question you asked, but since we are on the issue, it would seem to me that we should sell gold at the world market price to anybody who would be willing to buy gold for whatever currency, presumably dollars that they would be able to offer, at the world market price.

Chairman REUSS. I know you would agree with the second proposition.

Mr. MELTZER. Including American citizens at home who would be entitled to buy gold at the world market price.

Mr. FRIEDMAN. I would only add a couple of things.

First, Professor Meltzer in his statement referred to the snake, the European snake. I think he miscalled it a snake in the tunnel. It is no longer a snake in the tunnel, it is a snake on the river. You see, it was a snake in the tunnel when the tunnel was provided by the Smithsonian agreement. It is now a snake on the river because it is floating on top of the river. But I believe it is not long for this world. And we really do not have to worry about it, it is not going to last long, it will break down in the next 6 or 9 months. So it is a very temporary phenomenon.

Mr. MELTZER. I said it was hoped.

Mr. FRIEDMAN. Secondly, so far as the dollar overhang is concerned, I do not believe there is any problem with the dollar overhang. The people who have the dollars are free to do what they want with them. They can spend them in the United States on goods and services, give them away if they want to or buy American assets. And most of them have. The dollars that are held by foreign central banks are not being held, unfortunately, from our point of view, in the form of greenbacks wrapped in nice packages, they are being held in the form of U.S. Government securities on which we are paying interest. If they do not like the interest they are getting they can sell those securities and buy others. I do not believe that there is any problem of a dollar overhang that affects U.S. policy or about which the United States ought to do anything. I do not believe that we ought to engage in any venture to fund it or anything of the like.

Mr. MELTZER. On the contrary, we should remove the restrictions that now remain on portfolio investment abroad by Americans, that is, all the steps that were taken during the 1960's to do what was called defending the dollar. In a period of floating exchange rates we ought to be in the process of removing restrictions.

Chairman REUSS. Just one more related question. Since the beginning of the energy crisis a few months ago, there has been much talk about the year 1980 or 1985, when, if things go on as they are—and I am sure they will, but if things did—we, the United States, would have to buy an extra $10, $15, or $25 billion worth of oil annually from the Middle East, and these purchases would cause a great accretion of reserves in the Middle East. There is no assurance, it is said, that the holders of these dollars would want to use them at home. They might not find American investments interesting. And so this great

dollar pool would slosh around with all the attendant dangers. Do either of you have any insights on that that you would like to share?

Mr. FRIEDMAN. I do not know that I have any insights, but I have opinions. This is one of the rare areas at the moment where my opinions are optimistic. So I am delighted to express them.

I envisage the following thing happening in the course of the next 2 or 3 years, maybe 4 years. First, the gold bubble is going to burst. I am not saying that gold will come down below 125, it may go up to 200 and then burst. But sooner or later it is going to burst. It is a bubble like the Florida land bubble, the tulip speculation, and all such bubbles go too high and burst. And when the bubble bursts, much of the gold outstanding will be held by the Arab sheiks. And about the same time OPEC is going to fall apart.

The problem with the predictions you have been making is that people are making the enormous mistake of extrapolating present conditions to the indefinite future, which you must not do. At the moment the reason why price of oil is so high is because, with the assistance of unwise policies on the part of the United States, there has been formed an international selling cartel, the OPEC countries—oil-producing export countries. The cartel has fixed a price which is a multiple of the cost of producing oil in their countries. As a result, there is going to be tremendous pressure for that cartel to fall apart. Every country in that cartel is going to want to sell more than the international market will absorb at that very high price. I am judging the likely outcome on the basis of past history. There have been many international cartels and all have gone through this history. They last for a little while, but sooner or later there gets to be a chisler, there is always one in every bunch. And so one of the countries will be unable to resist the temptation to undercut the OPEC price a little bit in order to sell more. From this point of view—if I may go a little bit afield—some people in the United States have been deploring the fact that the Japanese have been tying down long-term contracts for oil. On the contrary, that is wonderful, because they will get themselves stuck with fixed commitments at a high price. Moreover, because they are out of the competition, the pressure is increased on the rest of the oil supply from the discrepancy between the pegged price and the market price.

So the second half of any prediction is that just as the sheiks are seeing their gold hoard decline in value, they will also see the bottom drop out of the world international oil market. Any predictions that 10 or 15 years from now, the United States is going to have to be expending enormous foreign exchange to buy extremely expensive international oil are simply invalid extrapolations from a present temporary position.

Chairman REUSS. I find your optimism profoundly depressing. And then we are going to go on polluting our atmosphere——

Mr. FRIEDMAN. That is our choice. If we want to restrict oil consumption for the purpose of pollution control, that is up to us to do. We can impose any tax we want to. As a matter of fact, we now have a very high tax on the use of the gasoline, which I suppose is probably higher than can be justified on pollution grounds. But if I am wrong—let us separate the issues. I for one think it is absurd for us to solve our pollution problem by encouraging an oil-producing cartel to

exploit us. If we believe that the social costs of using a gallon of gas are enormously in excess of the private cost, then let us eliminate the discrepancy by Congress imposing whatever tax in your wisdom you believe is appropriate for that purpose. We do not have to go the route of subsidizing OPEC.

Mr. MELTZER. I would like to add a point which I hope was not lost in the previous discussion. And that was on the benefit of a voluntary arrangement for a uniform currency for the world.

The main benefit is one which not only benefits the United States but benefits the whole world. There are large amounts of resources being used. Some of them were represented here, I guess, this morning or yesterday, people who were trading one currency for another in order to protect their position or in order to profit from trading. And that is a perfectly valid and legitimate exercise or an effort to protect their own interests. There is nothing harmful about such trading from the standpoint of private individuals. But there is a waste of resources in such activity, and there is a waste of resources if countries, or governments, try to maintain fixed exchange rates. That waste of resources could be eliminated if we had a world money.

I believe we were on the way to a world money—that world money is the dollar. You could find the beginnings. Individuals in London could write dollar checks and have them accepted by merchants in London. You can still go out and pay U.S. dollar bills in Canada and have them accepted.

I believe that with stability, the system would spread. As the system spreads it eliminates the resources that are tied up in places like the Euro-dollar market, in the various banks that are engaged in currency operations to maintain positions in various currencies, the operations of tourists who exchange one currency for another—all those resources which are tied up are released to more socially useful enterprises. I think that is a great stride that can be made with the return to the stability of the dollar.

Chairman REUSS. Congressman Brown.

Representative BROWN. I hardly know where to grab hold here. I have missed a good part of it, I know. But I am fascinated by some of the things that you have said in the last few minutes.

With reference to the comment about energy that Mr. Friedman made, I suppose that in effect it serves the oil shiek right, because it did not cost him anything in the first place. Those oil shieks are going to get stuck with nothing, and they did not have anything to start with. They will have a little gold, and still apparently will be able to trade some oil, so I assume there will be some use for it. They will not be all that badly off.

But may I ask for your comments, any observations that you have about what could happen in the meantime before that gold bubble bursts, with reference to the increasing reserves of dollars that the oil shieks have to call on to trade for gold in the market, or to trade for German marks, or whatever they might decide at the moment might be worth having. Is that not pretty disruptive?

Mr. FRIEDMAN. Not at all. They have the dollars, if they want to they can buy gold, and somebody else has the dollars. If they do not want to buy gold, they can buy American goods. If they do not want to buy American goods, they can buy American shares. They can buy American bonds. Why is it disruptive?

Representative BROWN. Well, the quantity in individual hands, I guess, is what I am concerned about; that seems to me to be the most disruptive part of it. The ability to suddenly come to a decision which may be quixotic and say, well, I am now going to dump all my dollars or my gold or my marks for something else, that keeps this pot stirred at least.

Mr. FRIEDMAN. From that point of view, Mr. Chairman, what matters is not simply the dollars held by the Arab sheiks or by foreigners, but all of the dollars held in the United States.

Representative BROWN. The fact that there are so many tops, is that what you are saying?

Mr. FRIEDMAN. No; consider your point for a moment, and forget about Europe. Could you not say the same thing, look, here are people in the United States who have $400 billion in currency and demand deposits; would it not be disruptive if they all of a sudden decided to take $200 billion of that and spend it on toothpicks, gold, or any other thing? And the answer to your question is, of course, if indeed the people who held money, who held the cash balances of the country, were inclined radically to shift it about from place to place, that would cause trouble. But why should we be more concerned about the danger from $30 or $40 billion held in foreign hands than we are from the $400 billion held at home?

Representative BROWN. If I may answer the question, my concern is that it is $30 or $40 billion held in many fewer hands compared to the $400 billion held in the hands of 200 million Americans.

Mr. FRIEDMAN. It is in many fewer hands, but it is still in a fairly large number of hands. The overhang which people mostly talk about, is mostly held by foreign central banks. And that is really rather a different matter than the private holdings. Nobody knows how much the private holdings of the sheiks and the others amounts to. But it is not the 65 or 70 million that people talk about. That is foreign central bank holdings. It might be better if the private holdings were in more hands. But I do not believe it really causes a great deal of trouble. This is a big country.

Representative BROWN. In terms of actual practice, this morning we got into discussing with some international bankers as to who the gnomes were. Do you want to identify those gnomes?

Mr. FRIEDMAN. Sure; I shall be glad to identify the gnomes. They are mostly the well-tailored, or gray-flanneled-suited treasurers of multinational corporations. The gnomes are people who are doing all of us a service. Far from being denigrated they should be honored, they deserve a gold medal. It was the gnomes that forced the governments to give up unrealistic exchange rates. It was the gnomes that have led us to a more——

Representative BROWN. Like the speculators in the stock exchange.

Mr. FRIEDMAN. Like speculators in general, they serve a social function, they serve the function of preventing the rest of us from living in a dream world. We deplore them, but, for example, if soybeans become scarce, for whatever reason, because the crops are bad, or because there is a sudden increase in the demand for protein all over the world, the speculators get wind of this in advance, and they start buying up the crop, and they start raising prices now. The result is, instead of prices keeping down and soybeans getting depleted and all

of a sudden jumping way up, you have a more gradual jump. They force us to face the reality that soybeans are scarce.

In the same way the gnomes forced the central bankers of the world to face the reality that the exchange rates they were trying to maintain were unrealistic. If I may go back to August 15, 1971, when Mr. Nixon cut the link between gold and the dollar, and when the result of that was the Smithsonian Agreement, as you and I know very well, the United States had been trying for a long time to get Japan to change the exchange rate. But we never succeeded. Who got Japan to change the exchange rate? The gnomes. It was the speculation that made it impossible for Japan to hold on to that exchange rate. So I think that this committee and all of us should give a plaque of appreciation to the operation of the gnomes.

Representative BROWN. And they do this to hedge their own corporate sales?

Mr. FRIEDMAN. They do it for their own interest, of course. But as Adam Smith said 200 years ago, you owe your daily bread not to the benevolence of the baker, but to his desire to pursue his own self-interests.

Representative BROWN. You talked about gold and soybeans. And you just raised a thought in my mind as you were discussing the gnomes holding the price down instead of letting it suddenly jump up, that in the energy area we have pursued this course of holding down the price of natural gas at a time when we then took another political action, and that was in effect, to prohibit the use for energy purposes of high-sulphur content coal for worthy purposes, environmental protection. And all of a sudden we had a shift into that very much, much more popular environmental fuel, natural gas; popular economically, because it is a heck of a lot cheaper when you compare it to the other choices that you could go to. And now we have got a gas shortage, and an oil shortage as a result of the shift. And I suppose the argument is that we must see fuels relate to one another economically on an honest basis.

Mr. MELTZER. Absolutely.

Mr. FRIEDMAN. Let me make it clear, there is no oil shortage, and there is no energy crisis in any physical or technical sense. It is entirely a product of Government price fixing. As to the natural gas price fixing which you mentioned which provoked the so-called gasoline problems now, the volume of gasoline being produced is higher now than it was a year ago. But gasoline was subject to phase II controls. Under phase III gasoline was put back under control. There is no technical problem of a shortage, it is entirely a question of price control, the natural gas control, the phase II price controls, and the phase III price controls on gas. And now you have a freeze on gasoline prices. That is what is producing the appearance of shortage.

You know, economists do not know much. But there is one thing we know very well. We know how to produce shortages and how to produce surpluses. And in the oil area we are doing both. By holding down domestic prices we are producing a shortage. By encouraging the OPEC countries to hold up international prices we are going to produce a future surplus.

Representative BROWN. Perhaps you feel that my questions have no relationship, but I want to switch now from the imbalance of energy series to the imbalance of currencies, and request if—I would

ask this of Mr. Meltzer—if your comment about the dollar as an international currency was precisely what you meant, because it seems to me that we do not have the dollar necessarily as an international currency, but rather with the floating system we are having all currencies in effect being international in that they are all related one to another on a movable basis; the dollar becomes unacceptable only as it is either, A, unpopular by comparison to other currencies, or, if you had a frozen system, B, uneconomically related to the other currencies and, therefore, not worthy at the exchange rate which has been artificially set Do you follow what I am saying?

Mr. MELTZER. Yes.

Let me try to break that down and see if I respond to what I think is the thrust of your question.

What surprises me, I think, most, in the recent period has been not that trade has continued to expand at a healthy rate but that most of the trade has been financed by dollars. Despite the floating system, despite the fluctuations in the dollar, most of the international trade has been financed with dollars. Now, that seems to me to indicate something about the costs of shifting to a multiple currency system. We are not going to shift to a multicurrency system unless the fluctuations continue to persist and remain for a much longer time than I hope they are going to remain. Even if the United States manages its economy very badly, I do not think that we will shift to a multiple currency system. What would happen is that countries, instead of pegging to the dollar as many have done, would find some more desirable currency to peg to. Perhaps the Swiss franc would turn out to be the currency or the German mark, the yen, or perhaps some other currency. Most transactions would gradually shift over and be denominated and carried out in those currencies.

Is that responsive to your question?

Representative BROWN. Only denominated in those currencies, because they can be carried out in other relationships.

Mr. MELTZER. That is right. But those would be the transaction currencies. And gradually as transactions were carried out people would begin to accumulate balances of those currencies just as they now hold balances of dollars. They would want to sell off their dollar balances. To give a historical example, at one time most of the worlds trade was done in gold and British pounds. The dollar was a distinctly less-important currency. Gradually the pound faded relative to the dollar as a currency for people to use as a medium of exchange.

Representative BROWN. Would you put that period of change at more than 25 years ago?

Mr. MELTZER. In the 1920's.

Mr. FRIEDMAN. 1914. The key change, really, was the outbreak of World War I.

Mr. MELTZER. And the British pound was freed from gold, and people began to shift into dollars. But it certainly became apparent by 1920 that the dollar was becoming the dominant currency, and it has so remained through most of the period. Now, despite recent policies I believe it remains the dominant currency. What will prevent the dollar from retaining its role over the longer term is continued instability in the rate of change in the domestic money supply and domestic policy.

Representative BROWN. That is what I wanted to get to, and that sort of runs me around in a circle. And that is the future of, A, the American money supply; and B, regardless of the supply, the credit or the faith, the faith behind whatever that supply is. And that is not a gold faith as much as it is a faith, I guess, or character. Is that a fair comment?

Mr. MELTZER. No; it is a faith in the value of the goods and services, assets, if you want, that people can buy with those dollars. They can buy assets in the United States, or if they prefer to have real assets rather than dollars, they can get rid of the dollars by coming here and finding someone with either land or plywood or lumber or goods and services——

Representative BROWN. Or shares in General Motors.

Mr. MELTZER. Or shares in General Motors—and they can get rid of the dollars. They have every opportunity to buy with their dollars. That does not eliminate the dollars, just changes the hands that hold them.

Mr. FRIEDMAN. But to go back to Mr. Brown's fundamental question—you really got off his main question—the faith that is important is the faith in the wisdom of you people in Congress, the faith in the wisdom of the people at the Federal Reserve, and the administration, and their management of the American economy.

Representative BROWN. The faith that we will not be just obliged to turn on the printing press and produce dollars which will be in effect worthless in order to, by such inflation, buy those social benefits that really come with the orderly growth of the society and industry.

Mr. FRIEDMAN. Exactly. And it is that faith that is most important. And that faith—the basis for it is not very great at the moment. It is not very great on the basis of our past performance, even though we have done no worse than other countries. Other countries have been just as bad. I am not trying to say that there is somebody who is better. And your committee—the Joint Economic Committee. I am not now speaking of the subcommittee—has played a very important role of a positive kind in providing some basis for that faith in your various recommendations for a stable monetary policy. This commitee played an enormously important role, of course, in the early 1950's in ending the pegging of the price of U.S. Government bonds and bringing about the Federal Reserve Treasury accord. More recently it has played a very constructive role in recommending a steady monetary growth rate. But unfortunately, your committee has not been able to get its recommendations adopted

Representative BROWN. One final question, because we have a vote, a question that relates to Watergate. Now, the concern was expressed this morning that part of the problem is that people around the world will look at the United States and think that the administration is devoting its time to Watergate and, therefore, is nct concerned with the economic problems. I will try to phrase the question in a different way. Was there any policy that seemed to follow the election, or any enunciated policy of the President that seemed to follow the election, in developing confidence in American policy in this area, monetary policy or fiscal policy, which has been slowed down by Watergate or not?

Mr. FRIEDMAN. Yes; I think that is a fair statement. I think whether justified or not there was developing a confidence that the United

States was going to follow a more restrained spending policy, that Government spending was going to be held down. And there was developing the belief that the Federal Reserve was going to follow a more moderate policy, again whether justified or not. I think as a factual matter you have to say that there was developing that belief, and that it has been very seriously eroded by Watergate and will be more seriously eroded by the consequences of the price freeze.

Representative BROWN. Because in fact the architect of that policy is now in some political trouble because of the Watergate, is that what you are saying?

Mr. FRIEDMAN. Yes; because—let me put it in a very different way, Mr. Brown.

Representative BROWN. I tried to put it in a political way.

Mr. FRIEDMAN. I am also going to put it in a political way. I am an economist and not a politician, and yet in this area economics and politics are closely related. I believe that if you go back and ask yourself, when did the present boom start in the United States—for just a moment leave aside Europe—when did this real boom start—I believe that it started to go off its former path about September or October of last year, and it started to go off the path when the public at large became persuaded that Mr. McGovern could not be elected.

Representative BROWN. That is when the boom started?

Mr. FRIEDMAN. Yes; because it eliminated people's uncertainty, because at that point there was widespread uncertainty about the character of the American economic or political system over the next 10 or 20 years if Mr. McGovern were elected and his policies were adopted. I believe that Watergate has reawakened that uncertainty, that its political effect has been to open up once again the possibility that you are going to have a runaway Government sector, with runaway Government spending, with more Government intervention. As a result, once again there is great uncertainty about what the shape of the economic system is going to be. I believe that that is a fundamental reason why the stock market is so low as well.

Representative BROWN. I am sorry that the press is not here, but I will remember those words.

Chairman REUSS. I will pass on to George your implied tribute that it was his appearance on the political scene which for many months held back the ravages of inflation. I think that is what you were saying.

Mr. FRIEDMAN. I believe that is true. As you know, I am not in favor of his policies, but I do believe that his appearance on the scene slowed down the domestic expansion, and that his disappearance from the scene speeded up the domestic expansion.

Chairman REUSS. On this happy note, I want to thank each one of you for a wonderful afternoon, and particularly our guest, Mr. Arriazu, for giving us a point of view which we could not otherwise have gotten and one which we are going to consider very carefully.

We stand in recess until 10 o'clock next Tuesday morning.

[Whereupon, at 4:15 p.m., the subcommittee recessed, to reconvene at 10 a.m., Tuesday, June 26, 1973.]

HOW WELL ARE FLUCTUATING EXCHANGE RATES WORKING?

TUESDAY, JUNE 26, 1973

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL ECONOMICS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:05 a.m., in room S-407, the Capitol Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representatives Reuss, Widnall, and Brown; and Senator Javits.

Also present: John R. Karlik, professional staff member; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF CHAIRMAN REUSS

Chairman REUSS. Good morning.

The subcommittee will be in order.

Today we are going to hear from a friend of the committee, Under Secretary of the Treasury for Monetary Affairs, Paul A. Volcker. Mr. Volcker has appeared many times before the Joint Economic Committee and this subcommittee as well. He played an instrumental part in bringing about the exchange rate changes that are necessary to restore the U.S. balance of payments to a position of strength.

We know you have a prepared statement. It will be received in full in the record. You may now proceed in any way you wish.

STATEMENT OF HON. PAUL A. VOLCKER, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. VOLCKER. Thank you, Mr. Chairman.

The question before the subcommittee—"how well are fluctuating exchange rates working?"—is of particular interest at present, both in connection with recent exchange market developments, and because of the implications for negotiations on monetary reform. At the same time, we have to recognize that conclusive answers are not yet possible for we are, to a large extent, operating in a new and not fully tested area.

At the present time, most of the major industrial countries are allowing their currencies in some sense to float—jointly in the case of certain EC and certain other European nations, and individually in other instances. This situation developed out of a broad consensus reached among the major nations last March that, in the light of

short term capital flows of unprecedented magnitude, greater scope for floating exchange rates would be appropriate pending more thoroughgoing reform of the international monetary system. This decision did not reflect any feeling that, following the February realinement, the existing structure of exchange rate relationships was inappropriate to foreseeable economic requirements. Rather, it was recognition that, in all the circumstances and given the time necessary to achieve equilibrium in underlying payments positions, recurrent speculative pressures could best be dealt with, and orderly monetary arrangements thus best assured, by permitting market exchange rates to respond more flexibly to the ebb and flow of funds through the exchange markets.

At a joint meeting of the Group of Ten and the European Community in March, those governments assumed no general obligation to intervene in exchange markets to maintain specified exchange rate margins, but agreed intervention could be useful at appropriate times and in particular situations in the interest of orderly conditions. In the event, there has been relatively little official intervention during the 3 months since that agreement, apart from the intervention by the participants in the joint EC float designed to maintain the exchange rate relationships among those countries. One exception has been sales of dollars recurrently by the Japanese authorities, with the yen-dollar rate remaining rather steady since mid-March. There have been sizable movements in some other market exchange rates, particularly between the European currencies and the dollar.

The EC currencies floating jointly have risen on the average by about 9 percent relative to the dollar. Changes between the dollar and other currencies have generally been much smaller; weighted by our trade, the dollar since mid-March has declined in the market vis-a-vis all currencies by something in the order of 2 to 3 percent. Similarly, the trade weighted appreciation of EC joint float currencies against all their trading partners has been on the order of 3 percent or less, with the exception of Germany.

I continue to believe that the general structure of exchange rates established by the February realinement is broadly correct in that it provides a valid basis for the elimination of the long-standing U.S. deficit and restoration of international payments equilibrium. Indeed, developments in recent months with respect to our trade position reinforce the view that our competitive position has benefited in a major way from the two realignments of December 1971 and February 1973, and further important gains in our balance of payments can be expected. Plainly, the speed and extent of our success will, as always, be dependent upon our ability to restrain inflation at home and to maintain a sound domestic economy. The new domestic measures announced by the President are obviously relevant in this connection.

At the same time, we have to recognize that during this transitional period an unusual degree of uncertainty has been present. Our payments have been in deficit for so long, and the imbalance in our trade had become so large that some tendency to await more complete and "conclusive" evidence of change is perhaps natural. While economic analysis and econometrics certainly point strongly to a conclusion that the February realignment should provide a powerful thrust toward equilibrium, those forecasting techniques cannot provide certain "proof" of achieving that result. The process of change, after decades

in which the international stability of the dollar was taken for granted, has itself unsettled market expectations for a time. In the best of circumstances, the process of adjustment works only with substantial lags. Finally, and perhaps most fundamentally, the strong inflationary currents running throughout the world, together with shifting judgments as to the ability of one country or another to deal effectively with those pressures, have contributed to an unsettled atmosphere.

Against this background, I would suggest three broad conclusions may be drawn from recent experience, recognizing that in each area we still have much to learn.

1. Present arrangements in the exchange markets are appropriate to the present period of transition to a more satisfactory balance of payments equilibrium and to a reformed monetary system. This view is, I believe, shared by the governments of virtually all major nations.

The validity of this conclusion does not rest upon an endorsement of either the size or direction of recent changes in market exchange rates. Indeed, as I have suggested, in my view and that of most governments the exchange rate levels established in February are more nearly appropriate to the outlook over time, and the day-to-day movements in rates in recent weeks have often been larger than I would like to see. However, in present circumstances, the practicable alternatives to present arrangements are unsatisfactory. An attempt to fix now a rigid structure of exchange rates would risk a return to massive capital flows, increased restrictions, and intermittent closing of markets—precisely the conditions we want to avoid, and have avoided.

In contrast, present arrangements have permitted countries to deal with internal inflationary problems more freely, with less concern over triggering fresh flows of international capital, while maintaining viable international markets. In the process, European dollar exchange rates have fluctuated over a broader range than heretofore. I have already suggested that, in my judgment, the exchange rates established in February and March were broadly appropriate to adjustment needs. In that light, the further appreciation of most European currencies in recent weeks—while temporarily tending to reinforce the competitive adjustments—seems overdone and reversible. However, the basic point is that after a period of change and uncertainty, businessmen, traders, and financiers need to become solidly convinced that the structure of rates is fully appropriate to present and foreseeable economic circumstances and has not been artificially contrived. I believe we must look to the performance of the market itself to help establish and reinforce such judgment.

We have not ruled out official intervention during this period. You have asked what guidelines might be established to govern such intervention. In testifying before the subcommittee last September, Chairman Burns and I described the administration's general policy with respect to official intervention at a time prior to the more widespread use of currency floats. I made clear that it was not our intention to prop up the dollar artificially counter to any basic balance of payments trends. We recognized that, in the end, the strength of the dollar must rest on other, more fundamental policies to improve our balance of payments. Any active intervention on our part would be under our own control, would be undertaken at such times and in such amounts—large or small—as we deemed desirable in light of market conditions, and would be for the purpose of helping to deal with speculative forces,

which can admittedly bring excessive and unnecessary turbulence and strains to money markets.

I believe that basic policy should continue to govern our approach in the new conditions of widespread floating. This policy is fully consistent with the agreements reached in Paris last March, which envisaged a cooperative international effort aimed at assuring an orderly system, while leaving intervention decisions to be worked out by each individual nation or group, flexibly and in close consultation with the authorities of the nation whose currencies may be bought and sold.

I doubt that it would be possible or useful to establish more explicit international guidelines at present, although more thought needs to be given to this in the context of longer range reform. For now, we want to maintain a flexible instrument that we can use in the interests of orderly markets, taking into account particular market circumstances at the time.

2. Such evidence as is available, while not conclusive for the longer run, suggests the present transitional arrangements have not seriously affected, in one direction or another, the volume of trade and long-term investment. Massive flows of short-term capital, which have been part of the pathology of earlier arrangements, have been dampened, partly by controls as well as by exchange rate arrangements.

In reaching this tentative conclusion, it is worth recalling that international trade has continued to grow over the past decade through thick and thin, crisis and calm, pegged rates and floats, at rates which are quite high by historical standards. Indeed, trade in most recent years has grown substantially faster than real GNP—a trend that sooner or later will presumably have to come to an end.

We know now that during the period of widespread floating in 1971, trade did not grow at appreciably lower rates than would have been expected, given the somewhat depressed rate of growth of business activity in the major industrial countries at that time. Comprehensive data are not yet available for analysis of the volume of trade flows during the present period of floating rates.

However, the information we have is consistent with projections by international bodies that the volume of world trade is increasing by about 12 percent per year. I would emphasize here that the general absence of new controls on trade is an important factor encouraging the growth of trade—probably far more important than any influence from exchange rate practices.

A comprehensive current picture of changes in the flow of international investment is still more difficult. Examination of the data on U.S. capital flows, however, does not indicate any noticeable fall in the level of long-term capital transactions during the period of floating rates in 1971 or more recently.

The subcommittee has already received testimony from business and banking spokesmen about the impact of floating rates on their operations. I can add little to their remarks, other than to report to you my strong impression that the exchange markets have been generally able to handle business transactions expeditiously. A particularly large transaction may take longer to accomplish fully, and some transactions for a period a long time ahead might prove more time consuming. But such difficulties—particularly of the latter type—were encountered under a nominally fixed rate regime as well.

There is some evidence that the transactions cost of purchasing forward cover—that is, the "brokerage charge" or the spreads between buying and selling rates—is now somewhat higher than in earlier years. However, these spreads, after widening during specific crisis periods, appear to have returned to levels that are relatively inconsequential in terms of the profitability of trade transactions—typically on the order of 0.1 to 0.2 percent for 3-month forward transactions. As experience is gained, some narrowing of these spreads would seem probable.

Similarly, in times of exchange market uncertainty, spot and forward rates have sometimes deviated quite widely, and the differences have departed from amounts justifiable solely in terms of interest rate differentials. However, forward discounts and premiums vis-a-vis the dollar for most major currencies have narrowed appreciably in recent months and generally have moved in line with interest rate differences.

Businessmen and bankers have certainly become more aware of exchange rate risks and practices in recent years. In this connection, we cannot reasonably compare a system of floating rates to a system—an idealized system—in which exchange rates never change. Obviously, every businessman would prefer certainty to uncertainty, no change to change. But that is a false choice—a permanently fixed rate system is not really available. In a dynamic world economy, with nations differing in rates of growth, productivity and price stability, changes in the terms on which international business is conducted—including exchange rate changes—will be necessary and will occur. The choice is not whether there should be changes, but what kind of change. I find few businessmen, for instance, that would prefer greater use of controls in exchange rates. I also find few businessmen who, in making longer run investment or marketing decisions, will not find it necessary to consider the possibility of changes in exchange rates, whether in a nominally floating or fixed exchange rate environment.

3. Present arrangements are not a substitute for agreed long-range reform.

The issues involved in long-range monetary reform go far beyond the question of exchange rate practices. At the most general and fundamental level, the question is one of developing those agreed codes of conduct necessary for governing behavior in an interdependent world. Each nation naturally likes to retain for itself as much freedom of action as possible. But where its actions impinge on others, we must face up to the need to assure that those actions are consistent with the requirements of the system as a whole.

International cooperation—fostered by the habits of the past, by recognition of the common interest, and by close consultation currently—has I believe met the present challenge. But, for the long run, cooperation will flourish not in a context of ad hoc decisions, but only in a framework of agreed rules, specified with some clarity and broadly perceived to be in the common interest. Such rules are now lacking. That is the basic task of our reform efforts.

In this effort, no consensus has yet been reached on specific exchange rate provisions. However, I think it is fair to say that recent experience has tended to increase support for the view that substantially greater flexibility in exchange rate practices than characterized the Bretton Woods system will be necessary and desirable. At the same time, the

view is widely held that international cooperation and surveillance of exchange rate practices is facilitated by retaining the concept of established exchange rates—par or central values. The question should not be posed as one between stability and instability, but rather, as the best means for achieving the highest degree of stability in the market, consistent with other goals and international cooperation.

The members of the Committee of Twenty in their March meeting expressed the highest common denominator of official opinion in this matter by suggesting the exchange rate regime should be based on "stable but adjustable par values," while recognizing "floating rates could provide a useful technique in particular situations." This formulation plainly leaves a great deal of room for differences in emphasis, and for means of making the concepts operational.

The views of the United States on this matter have been spelled out in considerable detail. The proposals put forward by Secretary Shultz last September took as a point of departure that most countries will want to maintain a fixed point of reference for their currencies, a central or par value. We recommended that around such central value there should be a margin for fluctuation—symmetrical for the dollar and for other currencies—sufficiently wide to dampen incentives for short-term capital movements and to ease the transition when a change in a central value is desirable. While changes in par values would remain subject to the initiative of individual countries, they would be a part of, and subject to, the rules governing the entire balance of payments adjustment process.

While in Secretary Shultz's words this framework of central or par values would provide a "center of gravity" for the system, in our view countries should also be permitted an option to float their currencies. However, a country floating beyond a brief transitional period should be required to observe agreed standards of behavior in other respects—including intervention—to assure the consistency of its action with the basic requirements of the adjustment process and of a cooperative order.

I believe we and others can learn much from current experience. I am not at all happy about what seems to me an unnecessary depreciation of the dollar in recent weeks, or about the size of some of the fluctuations in exchange rates from day to day. But I am satisfied that, during a period of great uncertainty in financial markets, exchange market pressures have been absorbed and diffused in a manner consistent with our basic goals and requirements, and those of other nations. Specifically, economic policies at home and abroad have not been distorted by the need to deal with massive flows of speculative capital in an atmosphere of crisis. International business has not been impaired. The basic processes of international adjustment are at work.

But we are also reminded by recent experience of certain fundamental facts. No international monetary arrangements can produce great stability if our national economies are themselves unstable and inflation-prone. International confidence must grow out of sustained performance at home. Our monetary techniques will be effective and durable only as they grow out of a broader international consensus and cooperation.

In sum, present arrangements are no panacea for our problems, or the end of the road of monetary reform. But they do seem to be working

for the present, and provide lessons and experience that must not be lost in our planning for the future.

Chairman REUSS. Thank you very much, Mr. Volcker, for a very comprehensive statement, and I think you have told us a thing or two that is new.

In your discussion of long-range reform, you spell out again the view of Secretary Shultz of last September and then, in your statement, you say:

While in Secretary Shultz's words this framework of central or par values would provide a center of gravity for the system, in our view countries should also be permitted an option to float their currencies. However, a country to observe agreed standards of behavior in other respects, including intervention, to assure the consistency of its action with the basic requirements of the adjustment process and of a cooperative order.

I rather like that. Does this not represent a friendlier attitude toward flexible exchange rates than existed prior to last March when we adopted the present arrangements?

In other words, does this not say that the wave of the future may well be flexible exchange rates and that if you can get agreement on international standards, you have it made?

Mr. VOLCKER. I do not think it goes quite that far, Mr. Chairman.

In the total context of our proposals, we are looking toward more flexibility in the exchange rate regime or exchange rate practices than under the Bretton Woods system.

We did propose as part of our plan last September that this option to float be included in any reformed system. We think that is an important feature of a reformed system. We thought so last September. I think our recent experience reinforces the wisdom of that view, though it is not a new element.

An option to float will be a most useful type of response. I think that is important that it be brought into the system. If I can propagandize a bit in terms of our own proposals, it does fit quite naturally in my judgment into a reserve indicator type of system, because intervention typically results in changes of reserves up or down, and this provides a handle, if you will, for bringing intervention practices into line with the operation of the system generally in that respect.

Chairman REUSS. You are, however, talking about indefinite floating maybe from here to eternity. Was that in the September formulation?

Mr. VOLCKER. Yes.

Chairman REUSS. It even envisaged floating forever.

Mr. VOLCKER. For individual countries. The system will have a par value basis. But that does not exclude situations in which individual countries might float.

Chairman REUSS. Individual countries like the United States?

Mr. VOLCKER. Well, I suppose that depends on what attitude one may take. I think in terms of a system which we have proposed, we presume that the United States would be part of the "center of gravity" implying a par value, and I think our plans in general envisage that.

Chairman REUSS. Turning to another point in your statement, you say:

An attempt to fix now a rigid structure of exchange rates would risk return to massive capital flows, increased restrictions and intermittent closing of markets.

Then you state:

> Any active intervention on our part would be undertaken at such times and in such amounts as we deem desirable, and would be for the purpose of helping to deal with speculative forces.

You have said previously that allowing exchange rates to fluctuate in the market is a useful deterrent against massive flows of capital across national boundaries.

Well, we like the parliamentary rules of the House, which permit interpretations either way. Are you going to call a massive capital flow a source of market turbulence that can be prevented only by avoiding a return to a rigid structure of exchange rates, or are you going to call such flows a reflection of speculative forces that impel you to active intervention to fix a rigid structure of exchange rates?

Mr. VOLCKER. Well, I do not think intervention in itself means a rigid structure of exchange rates. When you are protecting par values, you set intervention points and say you will maintain those points indefinitely. That is what I had in mind when I said rigid exchange rates.

I hope it is clear when I speak of intervention in exchange markets that we are not thinking in those terms, but in flexible terms to help maintain orderly markets.

Chairman REUSS. Well, we have in a sense a evolution regarding exchange rates. Floating came out of the developments in February–March 1973. We are 9 or 10 percent down from that at the moment.

But now, how, since you are likely to have in mind an underlying ideal structure of exchange rates and at times a movement away from that, how do you determine whether exchange rates have to be influenced through intervention or whether intervention should be avoided?

Mr. VOLCKER. I don't think we can use a statistical formula in these circumstances. In the end it depends upon some overall judgments on what is going on in the exchange market for a currency, and on what is going on in the rest of the world. It depends on what is going on now and on what is the reasonable outlook for the future.

Chairman REUSS. You still go along with the handy guide to intervention that I discussed with you and Mr. Burns a few weeks ago on intervention, "When in doubt, don't."

Mr. VOLCKER. I think we probably have been following that approach, but sometimes the doubts may be resolved the other way, and I do not want to exclude that possibility.

Chairman REUSS. How do you account for the 9 percent depreciation of the dollar against the European currency in recent months?

Mr. VOLCKER. Well, I am not sure I can fully account for it to my own satisfaction, but I do not think it is really appropriate when I look at all the circumstances. What I thought roughly was that the changes introduced in February were appropriate and I have not seen reason to change that judgment in the ensuing months.

I do think you can point to a number of factors that explain why we have had some fluctuations. This has been a very uncertain period. Changes have been made following exchange rate changes earlier—the psychology has been jarred by the fact that we have had a series of exchange rate changes. This makes the market more susceptible, I suspect, in the short run to fluctuations.

While it appears to me that the balance of payments is very much in a potentially strong position, it does take time for these changes to

work themselves out. So when someone is nervously sitting on the sidelines waiting for this to happen, he has to wait some period of time, which makes the market susceptible to speculative movements.

It is quite obvious that during this period we have had more inflation in the United States than was really anticipated some months ago. This is disturbing psychologically. We are moving in a forceful way to deal with the problem, but it is understandable that the inflation here has made some people nervous. Measures have also been taken in other countries to tighten up. So a variety of forces have come together to affect the market's behavior leading I think to an exaggerated movement in exchange rates, at least with respect to Europe.

Chairman REUSS. Do you agree with the view of many European monetary experts that Watergate has played its part in the matter?

Mr. VOLCKER. I am told it is in the background of some thinking and adding to necessarily uncertain judgments. In citing all of these, I think these reflections in the market have been somewhat exaggerated.

Chairman REUSS. How do you account for the fact that in spite of the President's anti-inflation speech on June 3, the dollar continued its decline in the marketplace?

Mr. VOLCKER. In the previous weeks the dollar had tended to strengthen, and then it moved back.

Let me go on and cite one other factor to try to understand better what has been going on. When one looks at our payments position in recent months—and you do not necessarily want to draw too many conclusions from a few months—but the evidence we have is that the trade balance is moving in a favorable direction more strongly and more quickly than we in a sense had a right to expect during this period. We have a trade figure released today—a deficit in May of $158 million, as I recall it. That is a relatively small deficit compared to what we had last year. In April we had a $200 million surplus and in February a $50 million deficit. We are thus roughly in balance for the last 3 months taken together. That represents some progress.

This real sense of progress here is all the more significant since this improvement in the trade balance has taken place during the last few months despite the advance in the domestic economy.

Chairman REUSS. Within the last few days a working paper of the Organization for Economic Development surfaced, reported in the press here, which worried a good deal about the excessive movement in exchange rates in a floating system. It talks about the danger of overcorrecting some rates and ends up saying the country concerned must be defending that rate.

Have you looked at that paper?

Mr. VOLCKER. No. I have seen the press reports that you have seen.

Chairman REUSS. What was your reaction to it?

Mr. VOLCKER. Well, my reaction in part is expressed in the comments in my own statement reflecting similar concerns, maybe in an attenuated form.

The recent movement in exchange rates seems to me excessive. I do not think they have done excessive damage, but I would not like to see them go on forever.

Chairman REUSS. Well, are you modifying the paragraph in your report on intervention and whether it will help deal with speculative forces. But suppose instead of turbulent speculative forces in the rest

of the world, foreigners do not like Watergate; they do not like the slacking off in the battle against inflation.

These are some of the things that are currently being pointed out. And so our exchange rate vis-a-vis other rates of currencies becomes very depreciated.

Well, would you say we ought to intervene in such circumstances? No speculation in——

Mr. VOLCKER. Well, it seems to me what you are——

Chairman REUSS. No turbulence?

Mr. VOLCKER. This is speculation. The speculation is due to the psychology surrounding the United States, in your phraseology. If there were no speculation, if this turbulence were based on a solid view of the balance of payments, the reasonable prospects. I would have one view. If it reflected what appeared to be a temporary overdrawn psychological situation, one might view it differently.

Chairman REUSS. Well, my difficulty with the OECD working paper is that it talks about exchange rates getting so far out of line that the process of recovery is impaired. It sees exchange rates as an evil in themselves that may be corrected by central banking. It sees corrective action coming out of Basel.

So are we going to move on the road to intervention or not? I would hope not, because the injunction you have in there is that we are going to intervene when and only when we must deal with turbulance in international markets. But what if the decline in the dollar is due to the cussedness of Europeans and Japanese and multinational banks who take a dim view of the dollar—a very dim view that seems to you and to me to be justified by current production and price indices and current balance-of-trade figures, which indeed seems to be the case right now? This is what these fellows seem to be talking about.

I commend you for not having reached for the whisky bottle, but in doing this you have not done the most commendable thing. I have just objected to the OECD recommendations.

Mr. VOLCKER. Well, I have not read the OECD paper.

Chairman REUSS. Well, the New York Times——

Mr. VOLCKER. I am not too sure that that accurately reflects the OECD paper. I do not know what they mean by excessive or turbulent or whatever adjective they use. It is not very useful to try to pin down some paper I have not read.

Chairman REUSS. I will have it on the basis of your accomplished statement this morning.

Mr. VOLCKER. I am happy with that statement. I am not saying anything different. I am not attempting here to say anything other than what it states.

Chairman REUSS. Good. If we stick to it, we cannot go wrong.

Mr. VOLCKER. We may have differences of opinion on what the words mean.

Chairman REUSS. During the very interesting testimony of Mr. Milton Friedman last week, he was asked about the dollar overhang. What do you have to say to that? I will read this:

> So far as the dollar overhang is concerned, I do not believe there is any problem with the dollar overhang. The people who have the dollar are free to do what they want with them. They can spend them in the United States on goods and services, give them away if they want to, or buy American assets.

Is it that simple in your view?

Mr. VOLCKER. I do not think it is quite that simple, I have not been one of those that thinks the overhang is necessarily the primary problem of the system. I do not think it is People presumably worry about the overhang because it is an element of dollar holdings that can be shifted from one form to another, and people are concerned that this may be done in a way that may have a short run or maybe even longer run disturbing impact. I suppose that that is possible, but I do not think these balances are less stable than the great supply of balances that are within the United States or other countries.

These other balances can also be shifted in international markets quickly. So the dollar overhang is part of a much larger problem of the amount of liquidity that exists in the world, and the fact that this liquidity can be shifted from one market to another quickly and shifted into the market in the short run. I am not inclined to pick out the overhang as a unique problem, but it is part of a larger problem. This is a problem we have tried to come to grips with in part in the current arrangements.

One of the benefits we hope to get from these current transitional arrangements, in which the exchange rate itself can flex and be resilient in the fact of potential movements, is that these funds, whether the overhang specifically or other liquid balances, will be less inclined to move and less disturbing when they do move in terms of interfering with the domestic monetary policy of various countries.

The fact that the exchange rate may move a bit will discourage the movement and set up countermovements.

Chairman REUSS. If you have a chance to look at and hear the talk of Mr. Meltzer——

Mr. VOLCKER. Again my——

Chairman REUSS. He and my sources seem to indicate that he believes that fluctuating rates prevent liquid capital——

Mr. VOLCKER. I think that——

Chairman REUSS. Is that about what you are saying?

Mr. VOLCKER. I think there is a good deal to it. I think it is an important option—one of convenience and necessity—in response to this problem—think it is one of the more effective ways, maybe the most effective way, of helping to deal with this problem.

Chairman REUSS. Before this subcommittee Mr. Allen Meltzer of Carnegie-Mellon University had the following to say:

> I believe the Congress should fix more definite limits on the aggregate swap agreement outstanding.

Can you give us the figures on the swap agreement?

Mr. VOLCKER. Well, I think they are in the area of $11 billion in terms of the aggregate, if memory serves me correctly.

Chairman REUSS. What do you think about a congressional limit on the amount?

Mr. VOLCKER. Well, I do not think it is a good idea, because if the swap network is going to be used effectively, it sometimes has to be used with a great deal of flexibility. I think Congress has a great interest in this area, and we have tried to work closely with the Congress in this area through a process of consultation. It seems to us that is the way to deal with the problem, rather than trying to sit down in advance and saying there is some rigid upward limit.

What appears to be a suitable upward limit in one circumstance may be entirely unsuitable in another circumstance.

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Chairman REUSS. On another subject, this subcommittee has recommended within the last year that the March 1968 two-tier gold agreement be modified so as to permit central banks, including our own, and the IMF at their discretion to sell gold in the free market.

What is your reaction to that suggestion?

Mr. VOLCKER. I understand the logic of that approach very well, but it involves, I think, relationships with other countries. It may have some implications for the long-run future, and we have not been able to work out a consistent approach toward this problem at the present time among all the countries that are involved.

Chairman REUSS. Are they not all in favor of allowing the sale of gold?

Mr. VOLCKER. Well, my judgment would have to be no, they are not all in favor of that.

Chairman REUSS. I had the impression that a bigger hangup was that some countries and their central banks wanted the right to purchase gold as part of the package.

Mr. VOLCKER. Well, there are some views and emphasis in that area.

I think there is a rather wide consensus, a very wide consensus, as one looks out into the future in terms of a new monetary system, that the dependence on monetary gold is to be reduced, reconciling with that the presence of gold and the present gold market circumstances.

There is a reluctance on the part of some to take concrete steps now before there is a full agreement on how the system may look in the future. This involves all sorts of nuances one way or another, but I am encouraged by the fact that the philosophical agreement, if you will, is so wide.

Chairman REUSS. You do not have to answer this question if you do not want to, but can you tell us the countries that object to removing the present prohibition on selling monetary gold?

Mr. VOLCKER. I think it would be unfair to try to characterize the position with respect to one element without trying to do it more fully, and I am not sure I am capable of giving a full exegesis of some countries, views with all the nuances.

Chairman REUSS. That answer is entirely acceptable.

Let me ask, do you think it would a good idea if we get an agreement to permit the sale of gold by central banks?

Mr. VOLCKER. Well, given——

Chairman REUSS. Pros and cons.

Mr. VOLCKER. Given other surrounding conditions and circumstances, it seems to me in the longish run that that is quite reasonable and desirable.

Chairman REUSS. I think in the subcommittee's mind and going back to last year, there were a variety of factors, that we could sell gold at $35 an ounce or $160 an ounce. That would be a pretty good deal, and we could use that gold to buy packages of foreign currencies, which is nice to have, or perhaps better still, buying securities. Secondly, we thought that it would not hurt at all to have a little gold supplied to show that while the gold market has gone up to $120 without causing undue difficulties for the world, nevertheless, the price is flexible downward also. To the extent that you have some central banks in there from time to time selling a little, this might aid in-

dustrial and artistic users of gold. We could not see, frankly, anything much against it.

Is that reason acceptable to you?

Mr. VOLCKER. That reasoning seems quite reasonable in my judgment.

Chairman REUSS. Suppose we should run into a country or two who say, we go along in selling—amending the 1962 agreement on sales of gold by central banks—but we want the right to buy gold, too?

Should that deter us? Is that so awful?

If they cannot buy gold for their central bank, because of rises in the price of gold in the free market, and changing the agreement lends a little more oomph to the monetary role of gold, by and large I cannot see anything so awful that we would not want to undo the March 1968 agreement, because others say all or nothing.

Mr. VOLCKER. I do not think I can say much more in this area than first, I think all these proposals have to be looked at in terms of a concept and a vision and an approach toward the longer range system. We believe the system of the future should not be dependent on gold—gold based, in the sense that even the Bretton Woods system was. We would want to look at all proposals of this sort against the basic objective of what contributes to the stability and effective operation of the monetary system and, as part of that, what makes the system less vulnerable to speculative or other influences in the gold market.

All of these proposals have to be judged against those general objectives. Some of these serve it and some of them do not serve it, in my judgment.

Chairman REUSS. Mr. Widnall.

Representative WIDNALL. Thank you, Mr. Chairman.

I regret I was not able to get here a little earlier to hear your testimony. I have just gone through it. I have a bit of knowledge of what is in it.

I would like to ask you a few questions that I think are fairly important.

If you could choose, what would you get rid of first, the Office of Foreign Direct Investment or the floating exchange rate system?

In other words, do you believe that our system of capital controls inhibits trade more than does a floating exchange rate system?

Mr. VOLCKER. I think I find it difficult to answer because I do not think either does. The OFDI's restraints, I think, have had a rather limited impact on direct investment, much less trade, apart from the means by which direct investment is financed.

As we discussed in the statement, I do not think the floating rates have greatly inhibited trade. I suppose the only way I can answer the question—I hate to give you such a round-about answer—is to say that we are certainly aiming at a monetary system which is not dependent upon the widespread use of controls.

We do want to get rid of the foreign direct investment controls. That is a major objective. And we are certainly willing to accept an implication that you need more flexible exchange rates as part of the bargain.

Representative WIDNALL. In other words, that goes hand-in-hand, side-by-side with the effort to remove restrictive barriers?

Mr. VOLCKER. Very definitely.

Representative WIDNALL. I have in mind some greater flexibility in exchange rates. That does not mean full floating.

Could you give us the Treasury's estimates of what our balance-of-payments picture will be at the end of the year?

Mr. VOLCKER. I cannot give you a precise estimate.

As I was suggesting earlier, we do think that the basic forces are moving toward improvement now of a decisive character, but it does take time. We have some very decided improvement in trade balance. We hope we can sustain that. It has been so great because of the particular situation in agricultural markets currently.

By the end of the year, we certainly will expect a pattern of an improving trade balance. I think with the improvement in our competitive position we will see less direct investment going out and more inflow, although the timing of that is always difficult to judge. I think tourism will be showing some improvement, an improved trend, and the elements of improvement will be reinforcing each other.

We had a very large deficit in the first quarter—these short-term moneys can move in and out. But as the rest of the balance of payments improves, the more basic balance of trade, you should see an improvement.

Representative WIDNALL. I just made my first trip to England, Oxford College. During the work of that trip I had the opportunity to talk to some of the English people in the lower income bracket. I found a very interesting result from that talk. Everyone I talked to insisted there are plenty of jobs available in England, and all that talk about unemployment was not as factual as one might think. It is just a case, in many instances, that the people do not want to take the jobs.

I think we have some of that in the United States when we keep talking about the horrendous unemployment rates, 5 percent. In England it is worse than that. It costs a lot more to live in England than it does in the United States.

My constituents seem to think that costs are going out the window with the rapid rise that is taking place here.

I wonder if you have a comparison of the inflation rates with the other countries that we can introduce into the record. I do not believe it is in the record.

Mr. VOLCKER. We can supply that, certainly.

In general, the inflation rate in the United States, as one looks back, say, to August 1971, when we suspended convertibility, has been better in terms of consumer prices than other industrialized countries. Our relative position has not stood out favorably in the last 3 or 4 months, it is true. We have been much more in the pack in the last 3 or 4 months, but in the longer period of time we have done relatively well, and I think lead the parade in terms of stability. We have not done as well in wholesale prices.

Representative WIDNALL. Will you submit for the record the experience of the last 2 to 4 years and then the experience in the last 3 or 4 months, what it is like in many of the other nations, also the comparison with respect to wholesale prices?

Mr. VOLCKER. We will be glad to do that, Mr. Widnall.

Representative WIDNALL. I think that would be very helpful.

[The following information was subsequently supplied for the record:]

TABLE 1.—TRENDS IN CONSUMER AND WHOLESALE PRICES FOR MAJOR INDUSTRIAL COUNTRIES, AUGUST 1971–DECEMBER 1972

	Consumer prices, percent increase at annual rates	Rank	Wholesale prices [1] percent increase at annual rates	Rank
United States	3.1	1	4.1	4
Canada	4.6	2	7.8	9
Japan	5.5	3	5.6	7
Belgium	6.1	4	3.3	3
Germany	6.3	5	2.4	2
France	6.6	6	7.0	8
Italy	7.1	7	—.1	1
United Kingdom	7.2	8	12.8	10
Netherlands	7.7	9	4.9	6
Sweden	10.8	10	4.4	5

[1] The index of manufactured goods is used for Belgium, the United States, Canada, United Kingdom, Sweden, and the Netherlands. The index of intermediate goods is used for Germany, Japan, and France. The index of industrial materials is used for Italy.

Source: OECD, "Main Economic Indicators."

TABLE 2.—TRENDS IN CONSUMER AND WHOLESALE PRICES FOR MAJOR INDUSTRIAL COUNTRIES, JANUARY 1973–APRIL 1973

	Consumer prices, percent increase at annual rates	Rank	Wholesale prices [1] percent increase at annual rates	Rank
Belgium	5.6	1	1.5	1
France	5.9	2	15.4	5
Sweden	7.5	3	18.0	7
Canada	7.9	4	18.6	8
Germany	8.3	5	[2] 14.0	4
United States	9.5	6	20.1	9
United Kingdom	12.4	7	3.7	2
Netherlands	12.6	8	([3])	
Italy	13.1	9	[2] 12.4	3
Japan	21.6	10	16.4	6

[1] The index of manufactured goods is used for Belgium, the United States, Canada, United Kingdom, Sweden, and the Netherlands. The index of intermediate goods is used for Germany, Japan, and France. The index of industrial materials is used for Italy.
[2] January through March.
[3] Not available.

Source: OECD, "Main Economic Indicators."

Representative WIDNALL. A number of subcommittee witnesses have expressed concern over the possibility that floating rates could encourage capital and other controls in international commerce. Do you think this concern is well placed?

Mr. VOLCKER. Well, I would rather put it in terms of disequilibrium that encourage controls. More recently you have had a proliferation of controls abroad which were, by and large, put on in times of fixed rates. That does not mean that the same phenomenon cannot appear in a floating rate environment, because people are tempted to resist fluctuations that a floating rate may bring. But I do not think it is right to condemn floating rates for bringing controls because fixed rates have brought them as much or maybe more.

I think what it tells us is that the more stability we can have, in turn requires more domestic stability, the better chance we will have

for living without controls and removing the controls that have been placed on transactions in recent years. I do not see it as primarily a fixed rate, or a floating rate phenomenon, although I suppose the most congenial regime for controls would be a rigid fixed rate system. If we were really going to try to fix rates, you would have a different philosophy regarding control.

Representative WIDNALL. A number of the business witnesses complained that the uncertainties of the floating rate system were making hedging operations more expensive, and that the additional expense of engaging in foreign exchange rate transactions made it more difficult to justify some foreign sales.

Do you think that the United States should adopt a dual rate for the dollar as a means of removing this uncertainty and guaranteeing a specified exchange rate for commercial transactions?

Mr. VOLCKER. No, sir. I do know that business is at best complicated by a control system—which puts transactions into individualized compartments which are not conducive to equilibrium throughout the world.

I question the basis on which your question is asked. We have looked into transactions costs. I made some reference to it in my statement. I think it is fair to say that these costs have probably increased.

If you take the more active traded currencies—take the Canadian dollar for example—there is no particular evidence of significantly greater transactions costs. With respect to continental European countries the increase in costs seems very small compared to the other factors influencing the profitability of international trade transactions. So I have doubt that this has been a really serious factor, apart from some particular crisis period immediately following August 15, 1971, or immediately surrounding February of this year.

When you get away from those periods, transactions costs, of course, have declined. Still for some currencies they are somewhat higher than they were before, but it does not appear to me enough to inhibit trading significantly.

Representative WIDNALL. Just one more question.

Are you satisfied with the progress on international monetary reform being made in the Committee of Twenty?

Do you believe that we shall be able to have an agreed-upon set of principles ready for the IMF annual meeting at Nairobi?

Mr. VOLCKER. I think we have a reasonable chance of achieving that objective. One is never satisfied, but in terms of the difficulty of the subject, the difficulty of the negotiations, I do think that the discussions are proceeding in a reasonable frame and mood at present. So I think there is some chance of reaching that target.

I think this leaves open the question of how much detail the principles include. There is quite a difference between stating a principle and stating it with a sufficient degree of precision to make it operational. I think we should go as far in that direction as we can.

Representative WIDNALL. That is all.

Chairman REUSS. Mr. Brown.

Representative BROWN. Mr. Volcker, you mentioned tourism a moment ago. What has been the impact of devaluation or what has happened to the dollar through tourism by foreign nationals to the United States?

Has there been an impact at all?

Mr. VOLCKER. I have not got any analysis which seems to me to offer reliable conclusions. I saw some reports in the press, as I think you did.

Representative BROWN. I did yesterday. That is what I am referring to.

Mr. VOLCKER. I saw some yesterday and the day before, but there has been reference—you can identify an increase in European and Japanese travel to the United States. We have a great beneficiary in the Japanese.

Representative BROWN. Pearl Harbor?

Mr. VOLCKER. It is a lot cheaper for the Japanese to come to Hawaii and elsewhere, and you can see a response. People are getting richer in Japan and it is cheaper for them to travel to Hawaii.

Representative BROWN. I was in Hawaii. I was there when the Japanese were there. It occurs to me that we are getting more foreigners in that area.

Mr. VOLCKER. I cannot give you any figures. We can get figures in the next few months.

Representative BROWN. What about the amount of tourism abroad?

Mr. VOLCKER. You have to sort out two influences. There is some evidence in terms of rate of growth. It is still growing, but it may be growing somewhat more slowly. There is also the influence of reducing the amount or time of travel. It is more expensive for the individual tourist when he gets abroad, so you may have fewer people going abroad or staying for shorter periods of time. At the same time he has to pay more per night, or whatever. How this works out in total is not clear. There is some evidence of slowing in the rate of growth of dollar expenditures. We will have more evidence later.

When a foreign tourist comes here, it is all net gain. When the American goes abroad, he has to pay the higher price, so you have an offset.

Representative BROWN. Well, we did our part here in the Joint Economic Committee by knocking out the SST so we could keep the travel time high.

In your statement you say:

> No international monetary arrangements can produce great stability if our national economies are themselves unstable and inflation-prone.

What factors do you see in that sustained stability that are significant? I suppose sustained productivity is one.

Mr. VOLCKER. I think prices, productivity, and profits. I suppose I can sum it up in the three P's in a sense.

Representative BROWN. Specifically, how are we doing compared to our trading partners or competitors?

Mr. VOLCKER. In terms of prices, by and large we are doing better.

Representative BROWN. As you said, until just——

Mr. VOLCKER. Until just recently, and that has shaken people up a bit, and it should, and it has led to a response.

Representative BROWN. In profits?

Mr. VOLCKER. In profits, we are doing better just recently. It is the reverse of the situation with respect to prices. We were not doing

so well before, during the period from the mid-1960's until the early 1970s, in the growth of profits, profit margins. We had in a sense a lag in profits for probably 5 or 6 years or even longer.

In productivity we are doing better again by and large in the past few years. In the late 1950's, we were not doing as well. This is again part of the other side of the profit equation during that period.

Representative BROWN. In other words, we did not do well compared to other industrial nations?

Mr. VOLCKER. If you compare our performance, there was a lag.

Chairman REUSS. This is the only thing I see we are lacking in the United States—it is the most productive economy in the world.

Representative BROWN. Do you think we are back on our productivity level or do you see a new picture?

Mr. VOLCKER. We seem to be on a long-term trend. We were actually on a long-term trend a few years ago. I think looking at this in the context of long-term trends, productivity seems to be growing in the neighborhood of 3 percent, maybe a little more than that.

Representative BROWN. Why did foreign nations do so well during that period of time?

Mr. VOLCKER. I think, in part, because they started out behind us. Take a country like Japan, with a well-disciplined, well-educated labor force. They have managed a very high rate of savings compared to us during this period, which is an important factor. They were able to put in place a lot of modern technology, a lot of modern machinery, so they caught up to the rest of the world, exceeded it in fact. They built modern plants in many industries upon which they concentrated. They suddenly caught up with us and stayed ahead of us in terms of world productivity.

Representative BROWN. They had a lot of temporary assistance such as the fact that we helped them after World War II with financial aid. But one of our difficulties, I understand, with most of these nations, our trading competitors, is research and development that exceeds ours.

Mr. VOLCKER. I think that is true in many instances. They have much higher depreciation allowances than we do.

Representative BROWN. The Japanese have more depreciation?

Mr. VOLCKER. They exceed ours in many countries. The British——

Representative BROWN. The British; the Canadians, too.

Mr. VOLCKER. And I believe the French—many of the industrialized countries have higher depreciation allowances or investment credits than we do.

Representative BROWN. In some cases, as a matter of fact, they permit the writing off of research investment, including capital investment at the beginning.

Mr. VOLCKER. Certainly some of them allow writeoff of capital in the first year.

Representative BROWN. So we are competing now on this basis where they have a more generous investment incentive for research and technology. Does that infer that we will have to move to that also?

Mr. VOLCKER. Well, we have moved somewhat in that direction, Mr. Brown. I think the relative performance in terms of support given to capital investment is now better than it was some years ago.

Representative BROWN. We had the 7-percent investment tax credit.

Mr. VOLCKER. That is right.

Representative BROWN. Is that enough? Are we going to have to go further than that as a matter of national policy?

Mr. VOLCKER. By and large I do not think it is as liberal as other countries have. We have competing priorities at home as other countries do. They placed higher priority on that particular area. How much further it is useful to go, I am not prepared to say. I do not think we should go back on what we have done.

Representative BROWN. American business benefits from that investment abroad, does it not?

Mr. VOLCKER. Yes, sir.

Representative BROWN. So if we do not have a comparable reserve and technological investment and benefit, then it becomes more beneficial to do research and technology in our own country?

Mr. VOLCKER. I just am not competent to talk about research per se. We have made some tax proposals that, as you know, would in some cases deprive American companies investing abroad of particular advantages of special tax benefits provided by some foreign countries.

Representative BROWN. Have you done any study as to the impact of Federal legislation in a restrictive area, such as the Occupational Safety and Health Act, and what that means to American trade, whether it is advantageous or disadvantageous?

Mr. VOLCKER. I have not looked at that particular area.

Representative BROWN. Has the Federal Government done a study in that area?

Mr. VOLCKER. I would hope this aspect is considered by those more directly concerned, but I will be glad to look into it for the record.

Representative BROWN. Provide it either to me or the committee.

[The following information was subsequently supplied for the record:]

The provisions of the OSHA do not call for studies of this nature. It would be extremely difficult to quantify the effect on our competitive position of the OSHA.

However, such studies are being undertaken in other areas, for example, as required by the Federal Water Pollution Control Act Amendments of 1972 (Public Law 92–500). Section 6 of this Act requires the Secretary of Commerce to report to Congress and the President within six months of the date of enactment on the potential economic impact of the evolving pollution control program in the United States and abroad. This initial report was submitted to the Congress and the President by Secretary Dent in April 1973.

Inadequate data and methodology precluded any specific computation, at the time the report was drafted, of competitive advantages which foreign producers may enjoy arising from differences in pollution abatement programs.

The report also noted that since the United States is in the relatively early stages of application of strict environmental controls, it may be some time before the most substantial cost effects reach the international marketplace in the form of higher prices. In future reports, an attempt will be made to isolate for special attention the instances where the most serious international market dislocations will occur.

The report also notes that other provisions of Public Law 92–500 call for federal action to encourage foreign countries to adopt pollution standards as strict as those established by United States laws. Adoption of the so-called "polluter-pays-principle" by all members of the Organization for Economic Cooperation and Development (OECD) in May 1972 represents a first step toward international harmonization of pollution standards. This principle is strongly supported by the U.S. Government.

Chairman REUSS. Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman.

I will detain you for only a few moments.

Tell us what you can about the alleged efforts of the United States to bring about a modification of the two-tier gold agreement of 1968. As you know, I have recently urged that we should be in a position to sell our gold stocks to commercial users, thereby preventing an enormous drain of $7 million on our balance of payments.

Mr. VOLCKER. I had some discussion with Mr. Reuss a little bit earlier and I think he recognized a number of points that I consider valid in this connection that are similar to the point you have just made.

We are operating here in a context of certain international understandings and agreements. We are operating in a context of looking forward to what is best in the long run. As I indicated earlier, we certainly in that long-run context strongly support the view that the system should not be dependent on gold, and that sales of gold into the market will be able to take advantage of higher market price, which certainly seems reasonable in that context.

How to work this out is another matter, for discussion, upon which there is not full agreement as yet. But I am somewhat encouraged by the degree to which the basic objective seems to be shared.

Senator JAVITS. Mr. Volcker, there is a contractual relationship with South Africa which expires in the spring of 1974. This will have an effect on the gold market.

Mr. VOLCKER. Well, that is a relevant consideration, but I would remind you that the South African Agreement has two sides to it.

It does place certain obligations and responsibilities on South Africa as well as on the rest of the world. There is a balancing of benefits from that agreement, and it will have to be looked at again.

Senator JAVITS. There is an opening again and that might be looked into.

Mr. VOLCKER. Right.

Senator JAVITS. The other question concerns the role of the essentially American based multinational corporations, in dollar speculation over the last few months.

Can you give us any appraisal of the role of the multinational corporation based upon your own view or the view of the Treasury Department in regard to speculation?

The question has two sections.

One, to what extent is it speculative?

Second, what effect does this speculation have on multinational corporation in terms of the price they charge Americans for the goods they sell them?

Mr. VOLCKER. On the first question, research has not been available. We do not have it all compiled as yet. Any conclusion that one has at this point has to be quite tentative, and maybe in the end the information will not be good enough to give us good answers.

I must say on the basis of what we have, the role of the multinational corporation has been exaggerated, badly exaggerated. A very sizable proportion of the money that flowed out of the United States during the first quarter, and it was a large amount, seemed in one way or another to have been under foreign decisionmaking in a sense. A lot of it went out in bank loans, for instance, to foreigners.

It is hard to identify who they all are. Some of them are foreign subsidiaries of American companies, as a matter of fact, and it is very hard to sort that out.

It appears to me a good deal of American money could have gone out into Eurodollars, and it could have been in many cases from placements by many banks here. So you have a kind of two-stage process, the dollar outflow into Eurodollars, and then from the Eurodollar market into a foreign currency.

It is hard to trade that kind of transaction. Foreign countries play a part in this transaction. It did not appear that anyone individually was doing anything major, but it amounted to a lot of money in total.

I am not sure why any of this should be of particular cost to the American consumer. I think the MNC's have been able to accommodate themselves pretty well to the situation without any big gains or losses. That is my general impression. Therefore, these exchange market activities do not have a major impact on prices. This is distinct from the question of the impact of devaluation—when the importer has to pay a higher price because of the exchange rate charge.

Senator JAVITS. But your impression is, and it is an impression—that the multicorporation sales of dollars have not had any particular weighty effect on the exchange of dollar value?

Mr. VOLCKER. It is a question of adjectives. I am sure the multinational corporations engage in hedging operations. Maybe some of them engage in something that should be called speculation, but they are only one factor in a larger market.

Senator JAVITS. What would you say about the Arab held dollars received for Middle Eastern oil which is estimated now at about $15 billion per year and which is constantly increasing?

Mr. VOLCKER. Again one can only speak of impressions. Here is foreign money held largely abroad and we have very little evidence of the extent to which it is shifted around.

Again, my impression is that that could be exaggerated. I suppose what I am saying is that when you get these massive movements of money that we have had, it is probably wrong to think of an "operator" moving massive moneys around, but rather, it is a massive group of people moving money around. It is in part speculative action. It is a very wide spectrum of people involved in international finance and international trade, and it is very hard to pick out one type. It is really a group of people.

Senator JAVITS. Would you say there is not some sort of conspiracy that the dollar was not worth what it was selling for in international dollars?

Mr. VOLCKER. I do not hold to a conspiracy theory.

Senator JAVITS. Would you say that the dollar is undervalued?

Mr. VOLCKER. It would appear so to me.

Senator JAVITS. To me also.

There has been a lot of talk about the dollar overhang, $90 million consolidated under an international control.

Anything you can tell us that would educate us and the public on this subject would be helpful.

Mr. VOLCKER. I look at this in the context of a new monetary system. I think you can make a strong statement that some kind of consolidation or funding would be helpful in getting a new start.

I have felt, as we were discussing earlier, that there is a general problem in connection with the movement of short term capital. I think dollars in official hands can in some cases be moved from one currency to another. That is a great mass that we are talking about,

but it has to be viewed as part of that overall problem and not as something that is in and of itself a unique problem It is part of the mobile capital situation.

I guess the conclusion I expressed earlier was that it is part of this process of dealing with mobile capital in general. With a floating exchange rate, the exchange rate takes a bit of the pressure and burden, as opposed to changes in reserves.

Senator JAVITS. Is it fair to say that you see the consolidation and other action regarding dollar overhang as a settlement of the international monetary situation, an ad hoc situation where you made a deal with the industrial countries of the world.

Mr. VOLCKER. I think it is the former. I think it could be part of monetary reform.

Senator JAVITS. Do you want to say anything on that score?

Mr. VOLCKER. There is nothing explicit as yet in the question of monetary reform.

Senator JAVITS. May I——

Mr. VOLCKER. I may add to my answer that while there is nothing immediate, we have had some transactions with individual countries from time to time. I am not saying that sort of thing would not continue.

Chairman REUSS. We are grateful, Mr. Volcker, for your helpful and forthcoming exchange.

We stand recessed until tomorrow morning at this place at 10 o'clock.

[Whereupon, at 11:45 a.m., the subcommittee recessed, to reconvene at 10 a.m., Wednesday, June 27, 1973.]

HOW WELL ARE FLUCTUATING EXCHANGE RATES WORKING?

WEDNESDAY, JUNE 27, 1973

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL ECONOMICS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:05 a.m., in room S-407, the Capitol Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representatives Reuss, Widnall, and Brown; and Senators Javits and Percy.

Also present: Loughlin F. McHugh, senior economist; John R. Karlik, professional staff member; Leslie J. Bander, minority economist; George D. Krumbhaar, Jr., minority counsel; Walter B. Laessig, minority counsel, and Michael J. Runde, administrative assistant.

OPENING STATEMENT OF CHAIRMAN REUSS

Chairman REUSS. Good morning. The Subcommittee on International Economics will be in order for a continuation of its hearings on the effects of flexible exchange rates. We are privileged to have with us this morning another old and valued friend of the subcommittee, Mr. Arthur Burns, Chairman of the Board of Governors of the Federal Reserve System.

Mr. Burns, you prepared a very comprehensive statement which under the rules and without objection, will be received in full into the record. Would you now be good enough to proceed with your statement?

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. BURNS. Thank you.

I am pleased to appear before this committee o comment on recent developments in foreign exchange markets and their implications.

In assessing the exchange-rate arrangements that have prevailed since mid-March of this year, it is useful to recall a few historical facts. Starting in the mid-1960's, the balance of payments of the United States deteriorated with only minor interruptions. A trade surplus per year averaging more than \$5 billion in the mid-1960's vanished by 1969, and was converted to a deficit at an annual rate of over \$3 billion by the second quarter of 1971. For a time, particularly during 1968 and 1969, capital inflows offset the decline in the trade balance and kept the official settlements balance from reflecting the

underlying deterioration. By the late spring of 1971, however, the growing weakness of our balance of payments was already widely recognized. A little later, a massive movement of dollars into foreign currencies finally forced the United States in August 1971 to suspend the convertibility of the dollar into gold and other reserve assets.

The actions taken by the United States that August culminated in a realinement of the par values of major currencies at the Smithsonian meeting in December of 1971. No quick improvement of our trade position was anticipated in view of the lags with which exchange-rate changes affect international trade, and also because our economy was advancing with some rapidity at a time when the economies of our trading partners were generally sluggish. In fact, our foreign trade performance during 1972 turned out to be much poorer than had been expected, with the trade deficit soaring to about $7 billion. By early February of this year, after some renewed disturbances in exchange markets, foreign governmental authorities agreed with our conclusion that the Smithsonian realinement had not gone far enough and that a further devaluation of the dollar was needed to restore equilibrium in international payments.

This second realinement of currency parities was agreed to on February 12. In contrast to the Smithsonian realinement, under which virtually all countries established new par values for their currencies, Italy and Japan now chose to float their currencies, thus joining the Canadian dollar, British pound, and Swiss franc—all of which were already floating.

Once faith in a national currency is shaken, the process of rebuilding confidence is never an easy matter. The monetary authorities of the leading countries were confident that the exchange-rate pattern established on February 12 was realistic and that it would in time restore equilibrium in world payments. Nevertheless, the dollar once more came under severe pressure in late February and early March. Countries still committed to maintaining par values for their currencies were therefore forced once again to purchase large amounts of dollars in the course of their intervention, and then ultimately to close their exchange markets.

The disorder that prevailed in currency markets during this crisis period prompted international discussions that resulted in a further extension of floating among the major currencies. Most countries within the European Economic Community—West Germany, France, the Netherlands, Belgium, Luxembourg, and Denmark—chose, however, to maintain exchange rates among their own currencies within narrow margins, but to permit them to fluctuate more or less freely against the dollar. This European bloc was soon joined formally by Sweden and Norway and informally by Austria.

After the mid-March Paris meeting of finance ministers and central bank governors, exchange markets reopened. In the next few days the volume of activity was light, and exchange rates moved within a rather narrow range. Over the following weeks, markets continued to be calm as the volume of trading moved closer to normal levels. Fluctuations in market exchange rates differed little from those that had normally prevailed under the previous regime of fixed parities. In fact, the dollar did not move outside the range of 2¼ percent on either side of the central rates established in the February-March period. Thus

during April and early May, the average dollar price of 10 major currencies (those of Japan, Canada, and 8 European nations) appeared to have stabilized at a level some 19 percent above the exchange parities that prevailed in the spring of 1970—that is, prior to the Canadian float and the subsequent currency realinements.

In mid-May, however, the relative calm that characterized exchange markets during the preceding weeks ended abruptly. Movements of exchange rates became larger, and the dollar began to decline sharply further against the major European currencies. Over the 6-week period from May 9 to June 20, the dollar price of the mark, the French franc, and the Swiss franc rose by 10, 7, and 6 percent, respectively. The average appreciation during this period of the 10 major currencies previously mentioned was smaller—about 4½ percent; the main reasons being that the dollar price of sterling rose little, while the Japanese and Canadian currencies remained quite stable, and the price of the Italian lira actually declined.

The causes of the widespread further depreciation of the dollar in this recent 6-week period have been discussed extensively. I doubt if they can be identified with any great precision. My own impression is that the most important factor was the accumulating evidence that the moderate success which the United States had achieved in curbing inflation during 1972 was eroding. Other factors undoubtedly played their role—among them, the tightening of monetary policies abroad, the new restrictive fiscal policy in Germany, the spread of uncertainty abroad about the ability of our Government to handle economic problems effectively, and wild rumors that another devaluation of the dollar was contemplated. Not least important, there was a sharp speculative runup in the market price of gold, which reflected, and in turn generated, a growing distrust of currencies generally. This development was bound to focus particularly on the dollar, in view of the worldwide fears caused by the sudden discovery that its stability could no longer be taken for granted.

There may be some economists who view the recent decline in the international value of the dollar with satisfaction. I am not one of them. When a currency depreciates, a nation's effort to curb inflation becomes more difficult. For in such a case, the prices of imported goods rise, and their rise is transmitted to domestic substitutes as well as to finished products based on imported raw materials. Meanwhile, exports are stimulated; and if direct controls are simultaneously being applied to domestic prices, as is now the case with us, some troublesome shortages may develop in domestic commodity markets. In contrast to the earlier devaluations, which were needed to restore equilibrium to our international transactions, the May–June depreciation is unfortunate. If certainly cannot be justified on any realistic evaluation of international price levels or underlying economic trends.

Nor is that all. To the extent that excessive depreciation of the dollar should persist, the United States would, in time, develop an undesirably large trade surplus. In other words, we would then be transferring real resources on cheap terms to the rest of the world instead of putting them to use here at home. Such a development, besides being senseless from our viewpoint, could cause difficulties for other countries, most of which depend far more on foreign trade than does the United States. Still another consideration to bear in mind is that

persistent depreciation of our currency would, in time, undermine confidence in the dollar's role as a transactions currency, and thereby weaken the international role of our highly developed financial system.

Although the decline in the international value of the dollar since mid-May is unwarranted by the condition of our economy or our balance of payments, there has as yet been no intervention by our Government in the exchange markets. Those who are selling the dollar short—whether out of a desire for safety or quick profits—will probably be punished by the market itself. In any event, the central banks of the leading countries will not remain aloof indefinitely. The situation is being watched closely. As agreed at the March 16 meeting in Paris, we and the monetary authorities of other countries stand prepared to intervene to facilitate the maintenance of orderly conditions in exchange markets.

Under present circumstances, with many financial, commercial, and political issues still unresolved among the nations of the world, the present exchange—rate arrangements—which I hope will involve little central bank intervention—are bound to continue. These arrangements have their advantages. The impact on exchange markets of speculative purchases and sales of currencies can be reflected in rate movements that are eventually self-limiting. In recent weeks, we have in fact been able to avoid the crisis atmosphere that would have emerged if the monetary authorities were still committed to maintaining a particular set of exchange rates through unlimited official intervention. There has been no need to close exchange markets to shut off massive international movements of funds. In addition, several countries have found that the present floating arrangements enable them to keep a firmer grasp on the expansion of their money supply and domestic indebtedness.

Limited experience is always an ambiguous teacher, but it can still generate strong opinions. Many of our businessmen and bankers now view floating exchange rates as a desirable development, or at least as necessary or entirely acceptable in current circumstances. Many regard the uncertainty associated with these arrangements as inconsequential, or as no more serious in their business calculations than other sources of price or cost variation. Many believe that a return to a par value system will bring further episodic crises or new controls that would impede world commerce more than floating exchange rates. These attitudes contrast dramatically with the views held by most businessmen and financiers only a few years ago. Even some of my central bank colleagues—who traditionally, as you know, have been the staunchest defenders of fixed exchange rates—now seem to be accepting floating exchange rates with equanimity.

Thus, there is fairly broad agreement—among businessmen, bankers, and political leaders—that the present exchange rate arrangements have been helpful or at least tolerable. Thoughtful and prudent men recognize, however, that the present arrangements have not been in operation very long, and I believe that not a few of the businessmen and bankers who were enthusiastic about floating exchange rates in April have developed doubts since then. Any judgments of the future based on recent experience must therefore be quite tentative.

For the longer run, thinking of a reformed international monetary system, I remain skeptical about the desirability of a general system of floating exchange rates. I hold this view even though I recognize the usefulness of floating rates in particular situations, such as the present. Some reasons for my skepticism are as follows:

First, in my judgment, the floating exchange rate system which has figured so heavily in academic discussions is a dream that will continue to elude us. Even for a country with as low a ratio of international trade to GNP as that of the United States, the repercussions of exchange rate changes on the domestic economy can be substantial. Under a floating exchange rate system, governments are always apt to be subject to political pressure by business, agricultural, and labor interests for protection against large movements of exchange rates—which may mean new controls or central bank intervention or both. So-called "clean" floating is not a politically viable arrangement over the long run.

Second, a system of floating exchange rates may lead to political friction and competitive national economic policies. From time to time, suspicions will be generated that this or that country has been manipulating its exchange rate at the expense of the interests of its trading partners. In such an atmosphere, whether for defensive or retaliatory reasons, governments may impose controls on capital flows or on current transactions. It is true, of course, that suspicion and political friction may be present under any type of exchange rate regime. And we know from experience that governments often imposed controls on international transactions when they were trying to defend fixed exchange rates that were unrealistic. Nontheless, I fear that such problems would be greater with widespread permanent floating of the major currencies.

Third, the uncertainties associated with floating exchange rates may lead in time to some erosion of international trade, particularly in the case of equipment purchases that require long term financing and when profit margins are slim. These uncertainties may also weaken private foreign investment—especially in long term bond issues.

Fourth, exchange rate fluctuations under a floating regime may add further to the difficulties that some governments already have in carrying out suitable fiscal and monetary policies. There is danger, for example, that a temporary exchange rate depreciation will get translated into permanent price level increases through upward revisions of nominal wages. Moreover, floating exchange rates may themselves become a tool of business cycle policy, and thereby lead at times to neglect of appropriate domestic policies.

While I have such misgivings about floating exchange rates as the basis for a reformed international monetary system, I realize that international rules may be developed to minimize their undesirable effects. In any event, I do not approach the question of longrun reform in a dogmatic frame of mind. The objective of the negotiations currently underway should be to adopt that set of institutional arrangements which, in the balanced judgment of financial experts, is most likely to promote the orderly expansion of international economic transactions among countries—each of which will be pursuing the goals of high employment, improvement in productivity, and general price stability. The exchange rate regime is not an end in itself.

I also recognize that the Bretton Woods arrangements, despite their great contribution to the international economy of the postwar period, failed to achieve timely adjustments of exchange rates. In the future, exchange parities must not be allowed to become so rigid or unrealistic. Many changes take place in the world economy—for example, in national rates of growth in productivity—that require some change in currency parities. Furthermore, while we all hope that at least major countries will pursue sound, noninflationary policies in the future, we know that mistakes will at times be made. These mistakes, too, may modify the pattern of exchange rates that is appropriate for maintaining balance-of-payments equilibrium. Hence, I fully endorse the objective of developing an exchange rate regime that will be more flexible than the Bretton Woods system.

The approach of our Government to international monetary reform was outlined by Secretary Shultz last September in his address at the IMF meetings, and is embodied in the U.S. proposals to the Committee of Twenty. This approach assumes that in the new international monetary system most nations will maintain established parities for their exchange rates. A similar view was expressed by the Committee of Twenty in the communique issued at the close of their meeting this March. The communique stated that exchange rates must be a matter for international concern and consultation; that in the reformed system the exchange rate regime should be based on stable but adjustable par values; but that floating rates could provide a useful technique in particular situations.

The U.S. approach to international monetary reform does not envision a par value regime of the Bretton Woods character. The U.S. proposals provide for rather prompt corrective actions, including par value changes where they are deemed appropriate. The proposals recognize, moreover, that a realistic framework for a reformed international monetary system must permit a country to float its currency for a temporary—and possibly for a prolonged—period. In the latter case, however, internationally accepted rules of behavior would still need to be observed.

Under the U.S. plan, movement in a nation's reserves are assigned a central role in establishing the need for corrective action. We do not, however, propose a system of automatic responses to reserve movements. On the contrary, each country would retain a substantial degree of freedom in choosing the corrective measures that appear most appropriate in its circumstances.

An essential feature of the U.S. plan is that it would evenhandedly encourage adjustments by countries whose reserves were out of line, whether on the high or low side. The plan would operate on a principle analogous to that of workmen's compensation and no-fault accident insurance; in other words, remedial action would be expected of a country whose reserves either rose excessively or declined excessively, without attempting to allocate blame or fix responsibility for the remedial action on a "guilty" party.

Before concluding, I would like to comment briefly on the prospects for the U.S. balance of payments. For I believe that, as a result of the exchange-rate realinements of 1970–71 and early 1973, the outlook for our balance of payments has greatly improved. Altogether, by April of this year the dollar had been effectively devalued against other currencies by about 16 percent since mid-1970, and by sub-

stantially more than that against some of our strongest competitors such as Japan and Germany. This is a large adjustment, and it has substantially improved the international competitiveness of U.S. goods.

The exchange-rate changes of recent years are already beginning to have perceptible effects on both our exports and our imports. So far this year, there has been a marked improvement in the trade balance. The trade deficit in the period from March through May, the latest 3 months for which data are available, was at an annual rate of about $1.3 billion, compared to $6.8 billion for 1972 as a whole. Much of this recent improvement reflects a bulge in agricultural exports which is likely to prove temporary, so that the underlying gain is not as large as the raw figures suggest. We should be prepared for some temporary setback during the months ahead. But there have been solid gains. The value of nonagricultural exports in the March–May period was 18 percent larger than it had been 6 months earlier. New foreign orders for machinery in the first quarter of this year were 16 percent higher than in the third quarter of last year. Meanwhile, the growth of total imports appears to have moderated, although a sharp spurt did occur in May—probably a result in large part of the recent rise in the prices of imported foods and raw materials.

Later this year and in 1974, we may expect to see further gains in our foreign trade balance, not only because of the cumulating effects of our strengthened competitive position, but also because business cycle conditions are likely to change in our favor. The growth of real output in the United States has begun to slow to a more moderate and sustainable rate, which should dampen the growth of our imports. On the other hand, economic activity abroad, which is the main determinant of our exports, is continuing to expand at a vigorous pace. The improvement in our trade balance this year is therefore likely to gather momentum in 1974 and 1975, by which time we should be experiencing a sizable trade surplus for the first time since the late 1960's.

The improvement in the trade balance may well be accompanied by some improvement in other international transactions—particularly capital movements. With the dollar so much cheaper than it was 2 or 3 years ago, foreign investors are likely to develop a greater interest in acquiring American assets—business firms, real estate, or securities. There are already numerous indications of such a widening foreign interest. On the other hand, the higher prices that Americans must now pay for foreign currencies tend to diminish their incentive to build plants abroad or to acquire foreign securities.

This favorable outlook for the U.S. balance of trade and payment is, of course, contingent upon containing domestic inflationary pressures. I am greatly troubled by the high rates of inflation that we have experienced in recent months. No exchange-rate regime or international monetary system can work well if the major industrial nations, particularly the United States, fail to gain better control over inflation than we have as yet achieved.

A stable dollar is vital to the well-being of American workers and consumers. It is also essential to the continuing progress of our domestic and foreign business, to a healthier investment climate in our country, and to the maintenance of our international political stand-

ing. I therefore hope that this influential committee, while immediately concerned with the problem of floating currencies, will keep in mind the overriding importance of restoring stability to the domestic purchasing power of the dollar.

Thank you, Mr. Chairman.

Chairman REUSS. Thank you, Mr. Burns, and particularly for that last piece of guidance to this committee which I think can never be overstated. I would like to ask about that, the problem of inflation within this country.

Looking back at the first 6 months of 1973, in view of the very substantial inflation in the capital goods sector of the economy, would you agree that we would have been better off if we had reduced the investment tax credit and thus taken some of the steam out of that part of our economy?

Mr. BURNS. Yes; I think we would have been better off. I wish we had done that.

Chairman REUSS. Turning to another source of inflation, consumer purchases of durable goods, automobiles, television sets, refrigerators, other hard items, would it not have been wise to have imposed some sort of controls on consumer installment credit so as to damp down the excessive purchases? By that I mean the traditional size of the down payment and length of the term of the installment credit?

Mr. BURNS. That is not a proposal that I made in the past.

Chairman REUSS. I am aware that it is not. I just wonder——

Mr. BURNS. Looking back, with the benefit of hindsight, I would agree that it would have been wiser to have done that. But the increase in consumer durable purchases crept up on us and I, for one, was not prepared for it on the scale on which it occurred.

Chairman REUSS. Do you believe the 60-day across-the-board price freeze that has been imposed on June 13 is a sound move at this time?

Mr. BURNS. Well, something had to be done to slow down the rate of advance in prices. However, I think a 60-day freeze is a very long period for an economy in our present condition. There is an enormous difference between the state of our economy now and the state of our economy in the summar of 1971 when the freeze was initially imposed At that time we had considerable slack in the economy. Many people figured that a period when prices were frozen was a period when items could be bought at bargain prices, since after the freeze everything would go up in price. Well, that did not trouble us. Since we had substantial unemployment and a great deal of slack, any sizable expansion of economic activity was something we would have welcomed. That is not our present condition.

In the second place, while we had rapid inflation at that time, the rate of inflation was more or less uniformly distributed over the price system. That is not our present condition. We have had enormous increases in the prices of raw materials. Some have gone up 10, 20, 30, 50, 100 percent or more in recent months, while there have been much smaller increases in prices of finished industrial products and prices of finished farm products.

Now, when a freeze is imposed under conditions like that, many businessmen and farmers will find themselves badly squeezed. They may not only find that their profits are diminished, they may find

that they have to operate, if they operate at all, at a loss. Therefore, a long period of a price freeze under present conditions is undesirable, and I very much hope that the price freeze will not continue for 60 days—that it will be cut short.

Chairman REUSS. What would you like to see as the general shape of the so-called phase IV controls?

Mr. BURNS. Well, I think that I would like to see us work toward a system where prices and wages in key industries will be subject to review by a governmental board, but where the price system at large would be characterized by considerable freedom. I think that is the only way in which our economy can grow and prosper. At the same time, I think the transition to that kind of a system will have to be made gradually. What I would like to see done, rather promptly, is to have the freeze ended and cost passthroughs permitted in industries that can justify the need for higher prices. In sum I would like to see for the near-term future a return to something akin to phase II, but not entirely like it.

I think rent controls are undesirable, and I am not in favor of them, nor should we try to control the hundreds of thousands of very small business establishments over the country. Prenotification of price and wage changes in the larger firms will be essential for a period I think. But I would like to see that phase terminated before too long. We then should pass to a price and wage review board system with a minimum of controls.

But if I may add a word, when we speak of phase IV, most of us have in mind prices and wages only. We tend to forget that phase I was accompanied by a variety of changes in the fiscal area. I would hope that we will take some fiscal measures to accompany phase IV with a view to bringing our very severe inflation problem under better control and doing it in a way that will not damage the economy. If the price freeze lasts over an extended period, very serious damage can result. There are already signs of that at present.

Chairman REUSS. I am most happy to hear what you have had to say, and not that it matters, but I think I agreed with every view you expressed. And I think that fiscal steps need to be taken. One of the things wrong with the 60-day freeze is that it is not accompanied by fiscal steps, taxing or spending.

There are going to be some attempts at the so-called reordering of priorities. But this probably will mean on the spending side no great change because the reorderers just want to spend less on defense and space and more on health and education, let us say. A general tax increase does not appeal to me, principally because I can see some possible softness in the economy ahead and I would not like to turn off consumer spending power to that extent.

However, I propose to attempt again right after the recess in early July, at the start of the fiscal year, a single loophole plugging amendment to the measure which will come before the Congress on impoundment. The proposal is for a $168 billion spending ceiling. To this I would attach an amendment raising an additional $5 million by tightening the minimum income tax that was, you know, put on back in 1969. People generally have the feeling that the upper 5 percent of income receivers ought not to get away with too much by way of loopholes. This tightening would in general put a limit on such loop-

holes of half of the regular rate. Would that not be a good way of getting some fiscal sense into our economy? I do not say that is the only thing that should be done. And if that were done, would it not make your task, for instance, a little easier?

Mr. BURNS. I am in favor of increasing the minimum tax from its present 10-percent level, but I do not think you can raise very much revenue through that device. Therefore, while I am in favor of it, that in and of itself, would not go very far in alleviating the fiscal problem as I now see it. I think other fiscal measures are needed.

Chairman REUSS. I will just ask one more question on this. If other fiscal measures are needed, spending less, taxing more—we will discuss that at another time—would not as a matter of equity and fairness the general public feel a lot better about, for instance, an income tax surcharge on everybody if those at the top who benefit by these loopholes had at least a partial closing through the minimum tax?

Mr. BURNS. As I stated, I am in favor of an increase, but you and I might get into a debate about the precise figures.

Chairman REUSS. I was just using the Brookings Institution figure of $4½ billion, not much but every little bit helps.

Mr. BURNS. I do not know how high they wanted to push the minimum tax. It is not a matter that I have explored thoroughly. I would consider a figure of 20 rather than 10, let us say, but I do not believe that would raise a great deal of additional revenue. I do not think it would raise anything like $4½ billion, but I may be mistaken.

Chairman REUSS. I have many more questions but I would like now to call on Senator Javits.

Senator JAVITS. Thank you very much, Mr. Chairman. You are very kind.

Mr. Burns, I am very interested in your concept of taxation especially in relation to the size and speed of cars and also in the general need for belt tightening by the American people. I do not agree with the illusion that you can scoop up everything you need by just taxing the rich. Franklin D. Roosevelt tried that with a $25,000 income ceiling and he learned that it does not work.

Congressman Reuss, who has been my constant colleague in so many of these matters mentioned a surcharge on the individual. What about an increase in the corporate tax rate? What is your view on that?

Mr. BURNS. There are two tax changes that would appeal to me at the present time. One is a new tax that would yield some revenue, perhaps substantial revenue, and that would at the same time help us deal with the energy problem. Among the many proposals that are under discussion, the one that appeals most to me is a tax on the horsepower of automobiles, particularly passenger cars. This is a tax that individuals would pay—or not pay—depending on the kind of automobile they elected to buy. It would help to conserve gasoline, it would yield tax revenue, and it would be beneficial all around, in my judgment.

A second kind of tax measure that appeals to me is one that would be of a flexible character. No one of us can anticipate the future of the economy even a year ahead with any great precision, so I would not be happy with a surcharge levied for a year, let us say, on individuals or corporations. At the same time, however, I would look very favorably on a flexible investment tax credit under which the investment credit

could be reduced, or, in the event of a downturn in the economy, raised again—perhaps very sharply.

Similarly, I would look with some favor on a fiscal measure that does not quite fall in the tax category. This would be a plan for compulsory savings, but again of a flexible type. Let us say corporations would be required to put aside an amount equal to 10 percent of their corporate taxes. That sum would be locked up in the Federal Reserve in such a way that it could be released in the event of a downturn in the economy.

In other words, my thought is that we ought to try to siphon off some purchasing power but we ought to do it in such fashion that we could reverse gears and do so rather quickly if the economic need arose.

Senator JAVITS. Who in your judgment, Mr. Burns, should control the trigger?

Mr. BURNS. This is a difficult question and I have given a good deal of thought to that. It seems clear to me that under our form of government, this is an action in which Congress must be a full partner with the President. I would suggest, therefore, that the President initiate the action and that the Congress approve or disapprove under special rules. Under present reorganization act machinery, if the Congress does not act within 60 days, a Presidential proposal will become law. I think it would be better to require affirmative action by the Congress. In that case the Congress would be playing the role of a partner to a fuller degree. Moreover, it would not be very difficult to write legislation in a fashion that would give the Congress a still larger role.

For example, suppose that the investment tax credit were raised—that is not the immediate problem but I am looking to the future. Suppose the President came along with a proposal to raise the credit from 7 to 10 percent. The Congress under a special rule could modify that; it could lower it or raise it within a percentage or two. This should be a joint enterprise, with Congress playing a partnership role and being much more than a minor partner in the exercise.

Senator JAVITS. Mr. Burns, just as a matter of information I have introduced a bill, S. 1764, which proposes exactly the plan that you have outlined for the investment tax credit. I would like to say that I think in regards to the investment tax credit and to some form of impoundment of an increase in the corporate tax, I agree with you. The horsepower tax that you have proposed also appeals to me greatly. It is in effect a luxury tax, is it not?

Mr. BURNS. Right.

Senator JAVITS. Personally, I believe we cannot control or ration gasoline that way. I think you simply have to allocate gasoline and ration it to users if a real scarcity exists, not just a ruse to raise prices. Yet, I do believe it is a perfectly legitimate source of tax revenue.

Now, could you give us, Mr. Burns, any overall figure under present conditions of added tax money that ought to be available in our system in order to have a decisive effect on our inflationary situation? Now for example, Congressman Reuss mentioned that he had in mind a $4½ billion figure. If you could help us with any order of magnitude, either now or perhaps after thinking it over—however raised——

Mr. BURNS. I hesitate to give you a precise figure, but I would suggest that the figure should be larger than the $4½ billion mentioned

by Congressman Reuss. I would add this: No less important than the magnitude of the figure is the psychological effect on the business and financial community that such a recognition of financial and economic reality by this Congress would have. I think markets are greatly disturbed by the way in which our economy is being managed—and all of us are at fault. A move by the Congress in the direction of raising taxes preferably in a way that would admit a quick reversal or impounding of funds, would have an indirect effect through psychology that might be more important than the precise, quantative, direct effect from the siphoning of purchasing power.

Senator JAVITS. Mr. Burns, if I named an order of magnitude of $10 billion, would you jump up and down in rage?

Mr. BURNS. No; it would not shock me.

Senator JAVITS. Congressman Reuss said he never expects you to jump up and down.

Mr. Burns, before you leave the witness stand, in the first place, I think what you said is critically important and would you agree with me that the whole attitude of American business including the rich people on the whole—there are some exceptions—is very different than what it was in these terms and that rather than being hostile to exactly what you have testified to, they would welcome it, even though it means they pay more in taxes. Has that been your experience, as you are in pretty close touch with the business world?

Mr. BURNS. Well, that is certainly true of the business and financial communities. I would hesitate to speak for the population at large.

Senator JAVITS. I mention the business and financial communities.

Mr. BURNS. Oh, yes; as a matter of fact, if I may—I might refer to a recent experience. I had a number of our directors from all over the country in and I asked for a show of hands on higher taxes. I indicated we would not talk about amounts, or about kind, but simply moving in that direction. When I asked how many would be in favor, every hand went up.

Senator JAVITS. Fascinating. Mr. Burns, may I say before my question period is over that I have listened to you many times and I would like to pay tribute to you as a public servant for unparalleled devotion to duty, an objectivity which should be the envy of every other public servant and a high degree of patriotism which has rarely been duplicated in your's or any other job.

Thank you.

Mr. BURNS. Thank you very much, Senator.

Chairman REUSS. I know we all join in that.

Congressman Widnall.

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Burns, I heartily second what Senator Javits has just said about you and your own stewardship and your participation in Government as it has been through the years. We count on you as a fair witness who will seriously seek the right and try to develop programs that are best for our country.

I am intrigued by your mention of a horsepower tax. I think that that is something that could be most welcome. My own comment would be as far as automobiles are concerned, that most cars are built to go too fast. There is no place in the United States except on a speedway where you can use the speed and power that are built into

these cars, and it is perfectly ridiculous to have a speed limit throughout the United States of 60 miles an hour and to continue building 130-mile-an-hour cars which are just gas eaters and give people a sense of power. I wish that the American people would get as alarmed about automobiles, the deaths, the injuries, that go with the operation of automobiles each year, in the same way they do about, say, a Vietnam or abortions or things like that where the numbers involved are really negligible compared to the automobile business.

We have got a long way to go toward controlling the American people's appetite for cars that really they should not have because of the cost of operation and the speed and ability to maim that is really built into those cars.

Would you agree, Mr. Burns, that the phase IV regulations, when they are published, will constitute a significant international event? Can you give us your guidance as to what these regulations should provide, and are you satisfied with the amount of consultation being carried out by the administration prior to drafting the regulations?

Now, I have asked three questions there together. I will come back to the first one. Do you believe they will constitute a significant international event?

Mr. Burns. Well, they certainly will. What we do in this country will have an influence on economic policy throughout the world. In addition to that, what we do is bound to have an effect on exchange markets, on the international position of the dollar.

Representative Widnall. What would your guidance be as to what these regulations should provide? What do you believe the contents of the regulations should be, the overall picture?

Mr. Burns. Well, as I indicated a little earlier, I would move in stages. I would not return to phase II completely. I would move in that direction a considerable distance, however. I would not reimpose rent controls, for example, and I would not try to control the activities of very small firms. But I would have prenotification and mandatory requirements together with sanctions applied to the larger firms over the country and also applied to wage contracts. But I would not like to see a system like that last very long. I would like to see us decontrol progressively and then work toward a Wage and Price Review Board which would confine itself to major price changes and major wage disputes.

I think we ought to go as far as we can and as soon as we can to restore free markets to this country. A price freeze is a dangerous thing, and I hope that it will not last, as I indicated earlier, 60 days. It should be terminated, in my judgment, much sooner if at all possible. And that has a bearing on your last question about consultations. If you consult too long with too many, it will take you all of 60 days and more. I would like to see consultations carried out around the clock, and the price freeze ended rather soon.

Representative Widnall. You have twice emphasized the fact you would not like to see rent controls reimposed. What is the key to your belief that that would be bad?

Mr. Burns. Well, I do not know how Senator Javits feels about this, and the last thing I want to do is put my great respected friend on the spot, but I do not consider the rent controls that we have had in New York City all these years a success. My observation has been

that rent controls, where they have been used over an extended period, have generated slums. I think that in our country we have had home-building proceeding at a very rapid pace. Vacancy rates are now increasing in many parts of the country and the national vacancy rate is going up. I think the market itself will control rentals reasonably well.

Representative WIDNALL. In your testimony, you state a point made by previous witnesses, that the uncertainties associated with floating exchange rates may lead in time to some erosion of international trade, particularly in the case of equipment purchases that require long-term financing and when profit margins are slim.

Could the same judgment also be applied to a par value system with substantially wider bands?

Mr. BURNS. If the bands were very wide, much the same question could be raised, yes.

Representative WIDNALL. What about a system where par value changes took place much more frequently than at the present time?

Mr. BURNS. That again depends on the frequency. If par value changes occur as they do in Brazil every few weeks, then the question that I raised and that others have raised about floating rates would apply to such a par value system. On the other hand, if they occurred only every 3 or 5 years, as I would hope would be the case, I do not think that criticism would apply.

Representative WIDNALL. Mr. Burns, in your statement, you make the point that the Fed stands prepared to intervene in the exchange markets to facilitate the maintenance of orderly conditions. Has the Fed in fact intervened for these purposes since mid-March?

Mr. BURNS. No, we have not.

Representative WIDNALL. That is all at this time.

Chairman REUSS. Congressman Brown.

Representative BROWN. Mr. Chairman, I, too, would like to echo the sentiments that have been expressed by other members of this committee; that is, my great respect, our great respect for you not only as a public servant but in the role which you now hold.

I would like to pursue a couple of points with you.

First, about the prenotification sanctions, wage and price reviews, et cetera.

In effect, does not this amount to sort of the establishment of a structure of redtape which has as its objective merely slowing down or stretching out the price increases? Is that the objective in that? I gather you would also complain that is jawboning of some consequence.

Mr. BURNS. Well, I would hope that it would accomplish more than that—that on balance, after a period of time, the price level would not rise as much as it otherwise would. But when you speak of red-tape, it worries me just as much perhaps as it worries you. I think we need a transition. We will have to go through a period of controls—I hope it will be brief, I hope it will be measured in months only—before we can get back to a relatively free price system once again. I do believe that we probably will need a Wage and Price Review Board to deal with industries which do not operate on the principle of competition to the degree that we would like, and with some of our trade unions that likewise do not operate on the principle of competition.

Representative BROWN. So the effort is to persuade people to show responsibility. In other words, to substitute for a market mechanism which now takes place generally for the smaller businesses that are in a more competitive situation.

Mr. BURNS. I would say many of our large businesses also operate in competitive markets, but in some industries, the term or phrase "a free market" is a euphemism. It does not really describe events. that is true of some of our labor markets, just as it is true of some of our commodity markets.

Representative BROWN. Let me ask you about one of the commodity market areas. What about food? Do you think that the imposition of controls on foods to the degree that they have been controlled by phase III and a half or whatever we are in now for 60 days, or whatever period of time we are in it for, is a sensible permanent policy?

Mr. BURNS. Oh, I think it would be a disastrous policy. In fact, I think that much of it ought to be ended promptly.

Representative BROWN. There is some evidence that there has already been some disaster, at least from the phone calls we have received in our office with reference to certain food producers who, caught in the crunch, are unable to continue their operation because they either cannot obtain supplies to do it or because the price situation is such that they cannot economically do it and, therefore, are not able to continue.

Mr. BURNS. There is no question about that. In a number of food industries the freeze ought to be ended immediately. We will have serious trouble if we do not. I realize that this means uncomfortable news for the consumer, but there are some facts of life we just cannot escape from.

Representative BROWN. I hope that this advice gets through and is followed. I will not relax in my efforts to get it through since I figure I have a more influential advocate in you to that degree.

Let me turn to another subject here which you have mentioned which intrigues me in a sort of an unpleasant way. As somebody who holds the job you hold, which has a rather lengthy term compared to terms of even the Senators and Members of Congress, the $4½ billion tax increase and the enthusiasm with which it would be welcome to the business community, the figures I have, which are rough, indicate that corporate income tax will account for approximately one-sixth of the total Federal income, personal income tax for about a half, and social security taxes for about a third of the Federal income in 1973 and in 1974. That corporate income tax figure runs around $37 billion. Would that $4½ billion to which you make reference, $4½ billion or more, thereby logically be added to the corporate income tax structure where it would be enthusiastically received or did they receive it with enthusiasm because they felt it might be spread around among all of those sources of Federal revenue?

Mr. BURNS. The particular group that I referred to did not discuss that question. I think it would be reasonable to assume that if that question had been discussed, the general belief of this group would have been that tax increases, if they go into effect, should apply partly to individuals and partly to business firms.

Representative BROWN. If it were all applied to the corporate sector I am sure—well, I am not sure but I believe some of those hands

would have come down that went up to affirm the desirability of the tax. Would you concur?

Mr. Burns. I think you are probably right, yes. But I cannot be sure.

Representative Brown. The effort not to cite purchasing power, I assume, was the objective of the tax increase in part at least?

Mr. Burns. That is correct.

Representative Brown. Is there any other method by which that might be done that might be more politically likely to occur? It seems to me that it is asking for a fair amount of responsibility from the Congress and the responsibility which thus far has not been demonstrated with reference to the Federal budget or the fiscal situation over the last 2 or 3 years, either by the Congress or by the President, because we have had rather substantial deficits built into the budget that the President has held and then the Congress has taken its whack at them and not necessarily improved the situation. Is there any other alternative to a tax increase at this time?

Mr. Burns. Yes, there are alternatives. First, the Federal Government could reduce its rate of spending below budgeted targets. Second, monetary policy could be more restrictive than it is. And third, through moral suasion, perhaps the private sector would become a little more restrained in its spending propensity for a while.

Representative Brown. Well, let me hit those one by one, if I might. Expenditures. We do not seem to be having much success with restraining expenditures. The Congress and the President, being what they are, I guess, political animals, have terms somewhat shorter than your own. At least, we did not have much success last night in an effort to cut back HEW. Do you really predict the prospect of being able to control expenditures at the Federal level?

Mr. Burns. Am I predicting that? I will stick my neck out. Yes. I think Congress is a very responsible body. It has a Joint Committtee on the Budget that turned in an excellent report. I believe that that report was subscribed to by every member of that very influential committee. Congress acts slowly at times, perhaps frequently, but I think in the end Congress can do its duty and I am optimistic that Congress will.

Representative Brown. Would you want to predict what we will appropriate this year. Mr. Burns.

Mr. Burns. No, I am not going to predict that because my last statement, I must admit, is based partly on hope.

Representative Brown. As always, you are very polite and graceful and thoughtful. I hope you are accurate.

In retrospect, do you wish you might have turned the damper on monetary policies a little earlier or a little sharper?

Mr. Burns. In retrospect, I think it would have been better if we had moderated the pace of expansion a little sooner, yes.

Representative Brown. I have figures that demonstrate the increase of the money supply in the fourth quarter of 1972 in which we spent 9.2 percent, 6.1 percent, 8.1 percent, and 8.6 percent. In the first quarter of 1973 it was 1.7 percent. Where should this have been done in retrospect? In the fourth quarter, perhaps as far back as the third quarter? There was some turning down apparently in the second quarter but in the third quarter that resumed again.

Mr. BURNS. Well, our control over the money supply over short periods is very imperfect. We began applying monetary restraint as early as March of 1972. This is reflected in interest rates in very large part. The Federal funds rate in March 1972 was $3\frac{1}{4}$ percent. Yesterday it was $8\frac{3}{4}$ percent. It has gone up quite a bit. If you look at the record you will find that this Federal funds rate, which we control in large part, went up month by month since March 1972. So the policy of monetary restraint did get underway early, but we might have gone a little faster, and perhaps a little further.

On the other hand, I do not want to leave you with the impression that I feel that we went much too far in the growth of the aggregates. I do not think we did. If you compare the rate of growth of the money supply in the fourth quarter of last year with the fourth quarter of 1971, you will find that the money supply grew less rapidly than the physical volume of production. Therefore, monetary expansion was moderate. Looking back, however, I would have liked to have seen it a little more moderate than it was.

Representative BROWN. My time is about up. You have hit two other points, moral suasion and restraints in the private sector. Restraint in the private sector obviously could be accomplished by a tax "disincentive" of some kind whether investment tax or an income tax. But I have expressed some concern here in this committee and in recent days that the United States has no research or technological investment tax treatment at the Federal level comparable to some of our trading partner competitors wherein they are given great advantages in terms of, in some cases, 100 percent write-off in the year of investment on research and technological improvement investments.

How do you equate those two things? Would you oppose a large or advantageous tax write-off to American industry on research investment or——

Mr. BURNS. No.

Representative BROWN [continuing]. Would you provide that and a tax "disincentive" for the expansion of production at the same time.

Mr. BURNS. Let me comment on your question as follows. On the average, I would like to see the investment tax credit at a higher level than it is at present. Instead of being 7 percent on the average I think it ought to be 10 percent or even higher.

On the other hand——

Representative BROWN. General investment now is not specific to research or technological improvement, or is it?

Mr. BURNS. No. I am talking about investment in plants and equipment. I will come to your question in a moment.

On the other hand, I would like to see the investment tax credit vary between limits, let us say, of 3 or 4 percent at one end and an upper limit of perhaps 15 or 17 percent. At a time like this, I would like to see the investment tax recdit lower. On the average, though, I would like to see it at a higher level than it is today because I think capital investment in this country needs to be greater.

Some types of investment—for example, a good deal of expenditure now undertaken by business firms on antipollution devices and the like——

Representative BROWN. Unproductive.

Mr. BURNS. That is right. I think business firms ought to be allowed to write that type of expenditure off promptly, either treat it as a current expenditure or at least be able to write it off in 2 or 3 years.

Representative BROWN. May I just interrupt you at that point? Would you apply that to all social investments or only to environmental protection investments at this time?

Mr. BURNS. At the moment, I must confine my remark to the latter. As to the former, I would want to think more carefully about that and I would not now want to broaden my observation.

As to research and development, I think that ought to be encouraged by our tax system.

Representative BROWN. Do you want to put a specific figure on it, compared to what some of the other industrial nations are doing?

Mr. BURNS. No. I do not know enough to be able to do that, certainly not at this moment. I do think that we in our country have tended to neglect investment relative to other nations of the world.

Representative BROWN. Mr. Chairman, my time is up but I would certainly echo and say the decline in the number of American patents, and, for example, the increase in the number of patents being taken abroad is certainly evidence that there are some other indications that it is more profitable, to bring this back to a base of what we are discussing specifically in this hearing, there is considerable evidence that it may be more profitable in the long run for some American industries to invest abroad where they gain some advantages in these technological areas.

Thank you, Mr. Chairman.

Chairman REUSS. Mr. Burns, in the last week there has been another increase in the prime bank rates, 7¾ percent, instituted quite widely. Do you believe this is justified?

Mr. BURNS. I think under current market conditions it was justified; yes.

Chairman REUSS. What is happening to the availability of money and the cost of money for small business, local governments, homebuilding industry, and consumers?

Mr. BURNS. Well, I am not aware of any problem in that area. Credit is available to individuals, small businesses, and farmers. Interest rates for small business have gone up but not nearly as much as the prime rate. The prime rate in January 1972, was 4¾ percent; now it is 7¾ percent. The interest rate charged to small businesses, according to a continuing survey by the Federal Reserve Board, has gone up between January 1972 and April of this year by 64 basis points, a little over one-half of 1 percent.

And the interest rate on consumer installment loans has actually gone down. The interest rate charged by banks on installment credit for new automobiles this April was 22 basis points lower than in January 1972. On mobile homes, 30 basis points lower. On installment loans on other consumer goods, 7 basis points lower. On personal loans, no change at all. On credit card loans, there has been a slight increase, of 8 basis points. So we have had no problem in this area.

On the other hand, in the case of mortgage loans, there are some problems that are beginning to appear. The interest rates on mortgages have begun to rise. The rise has not been very sharp fortunately, as yet, but it may go higher.

Chairman REUSS. In your statement you say the growth of real output in the United States has begun to slow to a more moderate and sustainable rate. On the basis of that can we look forward to a reduction in interest rates sometime during the rest of this year?

Mr. BURNS. I do not think that in my capacity I ought to make any prediction about interest rates, but I cannot encourage the thought of lower interest rates in the immediate future.

Chairman REUSS. The growth of real output would imply a diminution in the demand for credit, I should think, and why would that not bring about lower interest rates, unless somebody is rigging them, which——

Mr. BURNS. No. Nobody rigs interest rates, Congressman Reuss. The money and capital markets are perhaps the most competitive market of all in this country.

Chairman REUSS. Putting that aside, why should not slower business produce lower rates?

Mr. BURNS. Well, I do not expect business to be slower. I expect business to continue growing and demand for credit will continue growing.

Chairman REUSS. But at a less rapid rate.

Mr. BURNS. That will depend on the rate of inflation. My reference to a slower rate of expansion in the economy referred to physical magnitudes rather than to monetary magnitudes. On the supply side, I do not see the Federal Reserve beginning to moderate its credit policy just yet.

Chairman REUSS. We have agreed many times before and I am sure we still agree that one excellent way of getting interest rates down is to restrain inflation effectively and remove inflationary expectations from the structure. That is still valid, is it not?

Mr. BURNS. It is not only valid but that is the supreme reality if we could ever achieve it.

Chairman REUSS. Turning to your excellent essay on arguments pro and con on floating exchange rates, I wonder if many of the difficulties you find with floating rates—and we invited you here to give the pros and cons of flexible rates—I wonder if many of the difficulties you have with flexible rates are not also present perhaps in greater degree with respect to fixed rates? For example, you say—this is your fourth difficulty and I quote: "Exchange rate fluctuations may add further to the difficulties that some governments already have in carrying out suitable fiscal and monetary policies."

Then later, however, you say: "Several countries have found that the present floating arrangements enable them to keep a firmer grasp on the expansion of their money supply and domestic indebtedness."

While I certainly agree not all is perfect with flexible exchange rates, I am wondering if a country cannot maintain more control over its fiscal and monetary policies under a more flexible exchange rate.

Mr. BURNS. It might. But you know, in writing that paragraph I had in mind particularly one country which decided to revalue its currency in the expectation that trade unions would not press as vigorously for wage increases and that the pace of inflation therefore would be brought under better control. That was the thinking in that country at the time, and as a result economic policy in that country was deflected from a wiser course. I expected little from it and little

was achieved in fact. If monetary and fiscal restraints had been applied instead of a manipulation of the exchange rate, the desired result could have been achieved more readily.

Chairman REUSS. Again, you say—I believe this is your third criticism of fluctuating rates: "That the uncertainties of floating rates may interfere with the sale of equipment requiring long-term financing, 3, 4, 5 years."

Mr. BURNS. Or 10 years in some cases.

Chairman REUSS. But do not the same difficulties exist under a fixed rate system? After all, when the change comes it usually comes with a thud and the seller of goods on extended credit terms or his financier is left holding the bag.

Mr. BURNS. Well, you know, it is easy to be dogmatic, and I try very hard not to be. So much depends on how a par value system would work. If you had a par value system under which changes were made very frequently, or if you had a par value system in which large, abrupt changes were made at very distant intervals, you might get a very undesirable effect on international trade just as well.

Yet it is surprising how much vitality there is in the business world. Businessmen do adapt. Will they adapt better to the one system than to the other? The impression that I continue to have is that if you have reasonable stability in exchange rates, international trade will have a better chance of flourishing. I would emphasize in particular the experience that small firms are likely to be subject to.

Large firms can adapt to a floating exchange rate system far more easily than small businesses. These are the ones, I think, that may experience the largest burden.

But let me note that the views that I have expressed here are born of a certain experience. Perhaps my views are colored unduly by my very vivid recollection of what happened during the 1930's. My somewhat skeptical attitude toward floating exchange rates does reflect, I am sure, that disastrous experience. My views are also influenced by the beneficent experience over a considerable part of the postwar period when we had stable exchange rates.

How something in between the Bretton Woods system and floating exchange rates would fare in comparison with floating exchange ratus is a very difficult question to answer. We do not have an empirical basis. I approach the matter with some skepticism. However, if you had examined me on this question 2 years ago, you would not have found even the degree of tolerance of floating exchange rates that is expressed in my statement today.

Chairman REUSS. I have read your statement very carefully and also that of Under Secretary Volcker yesterday, and I do not find any real difference of outlook between the views of the executive branch as expressed by Mr. Volcker and your own views on the major subject of this hearing, that is, fluctuating exchange rates, the rules regarding intervention and related matters. Do you feel that there is an executive branch view and a Federal Reserve view that markedly differs?

Mr. BURNS. I do not think there is, no. I should say, and this may interest you, because things do not always happen this way in government, that these two statements—Mr. Volcker's and mine—were written in complete independence.

Chairman REUSS. I am sure they were. Having in mind the independence of the Federal Reserve under our constitutional system and further the wealth of historical statements over the last years on coordination of policy, in the event that the Federal Reserve under a given set of circumstances deemed it desirable to intervene in exchange markets, and the executive branch deemed it undesirable, I take it that the Federal Reserve would abide by the wishes, right or wrong, of the executive branch. Is that a correct political science observation on my part?

Mr. BURNS. It is correct for one time, one time only. By that I mean that if we could not really reconcile our differences in that case, then the Federal Reserve would abide by the wishes of the administration. But if I thought that we had done something that was wrong, we would have a constitutional problem and, as I told you at the Gonzalez hearing, if such a problem arose, I would come to the Congress immediately and raise the constitutional issue.

I do not think that will happen. We have worked together. There have been differences, but in the process of reasoning and deliberation, we have always worked out our differences. I do not think that the likelihood of a genuine difference arising is at all significant; therefore, I do not think we have a problem.

Chairman REUSS. I have just one more question which I suggest can perhaps better be answered by your supplying some sort of a statement, though you are welcome to try to answer it now. I think the answer is quite lengthy.

I was interested in Congressman Brown's discussion with you, Mr. Burns, about the rate of growth in the money supply and particularly in the fact that the rate of money supply growth has been quite erratic. I know there are difficulties in Federal Reserve control The statistics are not all that at least Professors Friedman and Meltzer, who testified before us last week, would like. There is some problem of membership in the Federal Reserve and there are other problems concerning the mechanism by which the Federal Reserve somewhat indirectly affects the money supply.

It would be most helpful to the committee if you could at this point in the record supply some sort of a statement from the Federal Reserve System giving your impressions of the question of the effectiveness of Federal Reserve actions on the money supply and what you are doing to improve your effectiveness. I think the answer is a rather long one which is why I invite you to submit it for the record.

Mr. BURNS. I will be very pleased to do that, Congressman.

Chairman REUSS. I think this committee, in working with you, will want to do as much thinking as it can about these issues in the future.

[The following information was subsequently supplied for the record:]

It is useful to introduce this analysis of problems in controlling the money supply with a statement as to the broader perspective of monetary policy objectives.

Emphasis on the money supply as an objective of Federal Reserve monetary policy has varied with economic and financial circumstances. To the extent that the System has sought to control rates of growth in the money supply, it has generally been with a view to achieving that objective over a span of months. The powers available to the Federal Reserve permit reasonably effective control over a period of several months. Precise control of the money supply over shorter

periods is much more difficult. Fortunately, precise control of very short-term fluctuations in money is comparatively unimportant, since only the longer-lasting changes in money supply appear to have much economic significance.

Factors which limit the System's ability to control money supply in the short run include the indirect relationship between Federal Reserve actions and the money supply, the sizable and growing proportion of deposits not subject to Federal Reserve reserve requirements, the inherent short-run variability of money demand, and deficiencies in the adequacy and speed with which the statistics necessary in monitoring System actions become available. Some of these factors can also affect the precision with which longer-run control can be attained.

Over the years, the System has taken a number of measures to improve the effectiveness of its monetary control, including experimentation by the Federal Open Market Committee with various reserve targets as a means of influencing the monetary aggregates. Other relevant improvements, such as the need to extend reserve requirements to nonmember banks, have been proposed to the Congress.

The ensuing discussion of monetary control will focus, for convenience of exposition, mainly on the money supply as narrowly defined to include currency and demand deposits held by the public (M_1). Other broader measures of money supply include the consumer-type time and savings deposits held at banks (M_2) and at nonbank savings institutions (M_3). In formulating policy, the Federal Reserve necessarily takes account of the behavior of both narrow and broader measures of money supply as well as other financial indicators, including bank credit, interest rates, and the financial liquidity of institutions and the public. On occasion, the importance attached to factors other than M_1 has led to policies which have resulted in a markedly different behavior of M_1 than would have been the case if policy had been focussed on M_1 alone.

The relationship of Federal Reserve actions to the money supply

Actions taken by the Federal Reserve System affect the money supply indirectly. Through open market operations, the Federal Reserve can control with certainty only its holdings of U.S. Government securities. Purchases or sales of securities by the Federal Reserve add to or subtract from the level of bank reserves and hence the base supporting member bank deposits, which constitute the major portion of the money supply. However, it is important to note that factors other than System operations affect reserves, and also that the use of the reserves supplied is affected by behavior of banks and the public.

There are certain technical factors affecting reserves—such as fluctuations in Treasury deposits at Federal Reserve Banks and variations in Federal Reserve credit advanced in the check collection process (so-called "float")—that are highly volatile and difficult to predict in the very short-run. In any one-week reserve period these factors may provide more or less reserves than anticipated and thereby serve to enlarge or contract bank deposits. These technical factors can contribute to short-run slippage between Federal Reserve actions and the money supply. They are of negligible importance over the longer-run, however, since their fluctuations tend to be random and often self-reversing. In any event, they can be offset by open market operations within a short time after they are perceived. This is also true of currency in circulation, which is both a part of the money supply and a factor absorbing reserves, but for which data are very promptly available.

Thus, the Federal Reserve can directly control the reserve base with some precision over a reasonable period of time. In contrast, however, the System cannot exert direct control over the use of reserves by banks and the public. Banks may wish to hold excess reserves. While banks in the past two decades have normally maintained minimal excess reserves on average, the amounts are quite volatile in the short-run and often absorb more or less of the reserve supply than expected. These unused reserves would not, of course, support deposits.

The System also cannot directly control the public's preferences for various types of deposits. These preferences are influenced by the interest rate structure, by transaction needs, and by a wide variety of transitory and random factors. Depending on changes in public preferences, reserves supplied may be used to support more time deposits rather than demand deposits, or vice-versa. Thus, the extent to which M_1 or M_2 is affected by a reserve injection will depend fundamentally on public preferences for different types of deposits.

Changes in the deposit mix alter the multiplier relationship between reserves and deposits. If, for example, time deposits begin to expand rapidly, more reserves will have to be supplied if M_1 growth is not to be restrained as a result of the diversion of reserves to support more time deposits. On the other hand, if M_2

were the principal objective of policy, less reserves would have to be supplied. This is because a dollar of time deposits requires less reserves than a dollar of demand deposits, so that a shift to time deposits would mean that a smaller amount of reserves would have to be supplied to support a given combined total of demand and time deposits. For the monetary authority to recognize and react to these changes in deposit mix requires close and continuing observation of the current flow of deposit data—as well as continued research into factors affecting the demand for M_1 and closely related assets. Through such efforts, the Federal Reserve is usually able to adjust its policies sufficiently to bring the money supply back to its desired course, but often the adjustment takes a span of months to complete.

Changes in the structure of reserve requirements could moderate the impact of shifting deposit preferences on the relationship between reserves and deposits. For example, equal reserve requirements on demand and time deposits would improve the precision with which M_2 could be controlled. On the other hand, zero reserves requirements on time deposits would improve the precision with which M_1 could be controlled, but would further loosen control over M_2. Neither of these changes, it should be noted, are recommended here, because it is doubtful whether the structure of member bank reserve requirements by type of deposit should be greatly altered solely for the purpose of controlling a particular concept of money. The financial objectives of monetary policy are in practice broader than any single measure of money. And the reserve requirement structure itself has a long history and serves certain purposes other than monetary control, including liquidity functions.

Scope of reserve requirements

Whatever may be the most desirable structure of member bank reserve requirements, monetary control problems are made more difficult over both the short and long run because reserve requirements on certain money supply-type deposits held by nonmember banks and savings institutions are not subject to Federal Reserve requirements.

Nonmember commercial banks hold one-fifth of total demand deposits, and this percentage has been gradually increasing State-determined reserve requirements on nonmember banks are variable from one jurisdiction to another, and can be held in the form of cash, deposits with other banks, and (in some cases) interest-bearing securities. Holdings in the last two of these forms do not contribute to the monetary policy function of reserves, since the funds so used finance additional credit and deposit expansion. Hence, the state system of reserve requirements complicates the task and reduces the precision of monetary control.

The potential development at thrift institutions of savings accounts with transfer features similar to checking accounts poses a new threat to controllability of the money supply, defined on functional grounds to include such accounts along with demand deposits. As with nonmember commercial banks, nonbank savings institutions are not subject to Federal Reserve reserve requirements. To the extent they develop deposits of a money-supply type, the linkage between monetary reserves and deposits will be further loosened.

Because the existence of a long and growing body of institutions outside the scope of Federal Reserve reserve requirements is progressively weakening monetary control through the reserve mechanism, the Federal Reserve has recommended a uniform reserve structure applicable to all commercial banks (and also to thrift institutions to the extent that they develop accounts that are similar in function to checking accounts). Such a uniform structure would extend the scope of Federal Reserve reserve requirements to all deposits that are part of the money supply. It would enhance monetary control by increasing the predictability of response to a given injection of reserves. For the application of uniform reserve requirements to be fully effective in that respect, however, reserves of nonmember institutions would have to be removed from the stream of payments, by being kept on deposit at the Federal Reserve Banks or in the form of vault cash.

Short-run volatility of money demand.

While the indirect relationship between Federal Reserve actions and changes in the money supply makes it difficult to exert close control over the supply of money, volatility in the public's demand for money creates another kind of complication. Experience indicates that there are sharp week-to-week and month-to-month variations in the public's desire to hold cash at any given level of interest rates. Even from one quarter to the next, wide variations in money demand have been experienced.

At times these variations have been influenced by international flows of funds, changes in the level of U.S. Government deposits, and sudden shifts in investor attitudes. At other times, however, the variations seem to be essentially random, as might be expected in such a large economy as ours, characterized by huge money flows and in which the usual pattern of money flows can be upset for reasons (strikes, unusual weather, illness) that are not fundamental to the long-run course of money demand and supply.

In view of this short-run volatility of money demand, it has seemed undesirable to attempt to control the supply of money rigidly. Rigid control of supply in the circumstances would lead to very sharp short-run swings in interest rates, as changes in the demand for money are forced back into conformance with the reserve-determined supply.

Such short-run interest rate gyrations could have quite unsettling effects on financial markets generally. Substantial uncertainties as to financing costs could, for example, make dealers in securities more cautious in adding new securities to their inventories and in taking underwriting risks. This in turn would reduce the fluidity of markets and, over the longer run, tend to increase the costs of financing to ultimate borrowers. In addition, any financial uncertainties engendered by wide and uncertain interest rate movements could well have undesirable effects on business and consumer spending decisions.

While short-run interest rate variations would run a considerable risk of damage to financial markets, our research indicates that short-run fluctuations in the money supply have little or no significant impact on the economy. In fact, the economic effect of an overrun in M_1 over a six month period appears to be quite minor if it is followed by an offsetting undershoot over the next six months. Thus, monetary policy has generally gone some way toward accommodating the provision of reserves to short-run variations in the public's demand for cash, while aiming at maintaining longer-run growth of monetary aggregates on an appropriate path. In general, the impact of monetary policy on M_1 and on the economy needs to be evaluated by averaging out volatile short-run growth rates over longer periods of 6 months or so.

Adequacy and timeliness of statistics.

To keep monetary aggregates under reasonable control over the longer run, while avoiding disorderly market conditions, it is desirable to begin adjusting reserve-supplying operations as soon as possible when the aggregates tend to move off course. Thus, a smooth adjustment of reserve policy requires prompt information on current money supply growth.

The Federal Reserve obtains a continuous flow of daily data from large member banks, and weekly data from other member banks. Efforts are under way, however, to improve the accuracy of the initial reports, and to broaden the coverage of banks which report daily, in order to obtain more accurate money supply data with even shorter lags than now.

While the Federal Reserve is in the process of improving further the current flow of data obtained from member banks, a large data gap for nonmember banks remains. Information on deposits at such banks is available only two to four days each year, from the call reports of condition carried out by the Federal bank supervisory agencies. The growing importance of nonmember banks makes it essential to obtain much more frequent data from them. Staffs of the Federal Reserve and the Federal Deposit Insurance Corporation have been exploring ways of accomplishing this objective.

Over the years, certain structural changes in banking have resulted in distortions of money supply statistics. The greatly increased tendency to borrow from abroad by U.S. banks was one such change in the late 1960's, and the reduction in the level of float from Federal Reserve regulatory action in the early 1970's was another. These changes have at times occasioned sizable annual revisions in money supply statistics to maintain historical continuity. Policymakers have been alerted to these problems well in advance, and while the necessary revisions have sometimes complicated the process of carrying out policy, they have not significantly distorted the formulation of policy.

Experiment with monetary control by means of a reserve target.

As part of its continuing efforts to improve the monetary control mechanism and obtain more effective control of the monetary aggregates, the Federal Reserve in early 1972 decided to place increased emphasis on a total reserves target as a guide to its day-to-day open market operations. The reserve target was soon modified to a concept of reserves available to support private nonbank deposits

(RPD), so as to permit accommodation of reserves to the large day-to-day fluctuations in U.S. Government deposits that basically reflect Treasury cash management paractices and do not have any lasting economic significance.

The RPD experiment has gone through several phases, and the Federal Reserve continues to work toward further improvement in procedures. Initially, a fairly wide target range was set for RPD. As more experience was gained in operations and in estimating the multiplier relationship between reserves and deposits, the target range was narrowed.

While setting target ranges for RPD at each meeting, the Federal Open Market Committee also establishes ranges of tolerance for the Federal funds rate, a key rate indexing money market conditions. In doing so, however, the Committee has had to recognize and take account of the fact that increased emphasis on reserve targets normally can be expected to lead to wider fluctuations in the Federal funds rate than in the past.

Experience in 1972 indicated that even with the flexibility permitted by monthly Committee meetings, there was still a risk that reserve and monetary objectives could cumulatively move off target if the Federal funds rate range was made too narrow. Typically, that range has been widened in recent months. In addition the Committee has been willing to adjust the Federal funds rate range in the interval between meetings, if pursuit of reserve and monetary objectives appeared to require it and credit markets seemed able to adjust smoothly to the greater rate range.

It is doubtful that a completely foolproof means of controlling the money supply can in practice be developed. Improvements can and will be made both institutionally and in the statistical basis of operations. The Federal Reserve is continuously studying its own procedures with these objectives in mind. There will always remain, however, the larger question of what particular money growth rate should be targeted and how much weight should be given to such a target in comparison with other financial objectives in helping to achieve national economic goals. That judgmental issue is at the heart of monetary policy decisionmaking.

Chairman Reuss. Senator Percy, are you up to asking some questions now, or shall I call on Congressman Brown?

Senator Percy. Please call on my distinguished colleague.

Chairman Reuss. Congressman Brown.

Representative Brown. Mr. Burns, the most fascinating paragraph for me in your whole presentation is one that I find rather enigmatic. Perhaps that is why it fascinates me but perhaps it is the responsibility of the Chairman of the Federal Reserve System to be enigmatic.

Mr. Burns. At times he is; yes.

Representative Brown. And that is your fourth commentary about your concern about floating rates. I would like to frame the question this way. I do not see any reason to repeat the paragraph. We all have it before us.

What is the impact or can you relate for me briefly the impact between a floating exchange rate and your responsibility with reference to the discount rate and what happens to the domestic economy as a result of what happens to the international economy in the floating rate? Do you understand my question? It is not phrased too well.

Mr. Burns. Well, much depends on how the floating rate behaves. Take, for example, the Japanese yen and the Canadian dollar. Since last March or so, the Japanese yen has been floating and the Canadian dollar has been floating, but the exchange rate has been quite stable all the same.

Chairman Reuss. Floating together.

Mr. Burns. Well, it so happens that both have been stable relative to the dollar. Each country has made its own policy in the light of its own circumstances. But that is the way things have turned out. Therefore, the floating exchange rate, with regard to those two countries, has not caused any special difficulties.

On the other hand, the dollar price of the German mark, deutsche mark, the dollar price of the Swiss franc, and of certain other European currencies has risen very sharply of late and this is causing difficulties in our domestic economy—it is causing a rise in the price of many of our imports. The direct effect, as statisticians measure it, is quite small, but the indirect effects spread through the economy.

Representative BROWN. You say that there is danger, for example, that temporary exchange rates depreciation will get translated into permanent price level increases through upward provision of nominal wages. Are you saying, then, that as the dollar is depreciated certain international—certain export products, U.S. export products, will be stimulated in the United States and they in turn will raise their prices and have wage increases which might as the thing levels out find them in a position of exposure to where they cannot justify that position? Is that the analysis or do I misunderstand it?

Mr. BURNS. Well, my thought is rather, first, that prices of imports will rise, that will tend to spread through the price system, and the resulting increase in the domestic price level will have its effect on wages.

Second, exports may be excessively stimulated at a time when there is pressure on industrial capacity and this, too will lead——

Representative BROWN. Imports or exports?

Mr. BURNS. Exports. This, too, will lead to a rise in the price level The change in the exchange rate may be an entirely temporary phenomenon, but still by leading to an increase in the price level it may lead to an increase in wages which will be permanent and thereby affect the overall price level in the future.

Representative BROWN. So that in effect, our going to floating exchange rate a couple of years ago may now have some responsibility for the rather sharp increase in prices that we have in some fields in the domestic economy. Is that what you are saying?

Mr. BURNS. That undoubtedly is true.

Representative BROWN. Mr. Burns, on two other points very quickly, I have expressed my concern to you about the freeze on food prices and obviously, that is a parochial concern because I have some producers who are adversely affected.

Mr. BURNS. On the contrary, I think it is a national concern.

Representative BROWN. I trust it is a parochial concern. It ought to be of national concern but I look at most of my parochial concerns that way so it is a little difficult for me to judge. Your suggestion about an auto horsepower tax. Is that not in effect trying to cure a national problem by targeting in on one industry which could conceivably be rather adversely affected and sharply adversely affected by discouraging the purchase of American-made automobiles which are high horsepower automobiles as opposed to foreign products which are generally not as high horsepower, even though the purpose may be worthy from the standpoint of the environment, pollution, need for a lot of other Federal spending in highways, et cetera? Is that not kind of taking it out a little too hard in one rather limited area of the economy which could have ripple effects in a lot of other areas like steel, et cetera?

Mr. BURNS. Well, let me say this. First, in making the observation that I did concerning a horsepower tax, I was combining my concern

about the general problem of inflation with my concern about the energy problem.

Second, I have referred to one way of dealing with the energy problem through the tax side. There are other ways of dealing with the energy problem and I did not comment on those.

Third, as far as our automobile manufacturers are concerned, under the horsepower tax, I would suppose they would——

Representative BROWN. Adjust?

Mr. BURNS [continuing]. Adjust and produce a different kind of car or the mix of small automobiles or automobiles with small horsepower and larger automobiles with larger horsepower would change. The overall effect on the automobile industry need not be adverse, but I certainly would not want this one industry to carry the full burden, or anything like it, of the Nation's energy problem, and certainly not of the Nation's inflation problem.

Representative BROWN. Since it is a rather formidable part of our economic prosperity in Ohio——

Mr. BURNS. I did not say a word about it, but there has been a good deal of discussion on this question, as you know.

A gasoline tax is being widely discussed and it has seemed to me that a horsepower tax would be preferable to a gasoline tax——

Representative BROWN. Before we could even lower the speed limit to 45 miles an hour and let the municipalities and State highway patrols around the country raise the fines on everybody—we would—could help local government.

Mr. BURNS. We could do that. But I do not see much sense in producing automobiles with enormous horsepower and not permitting the owners of the automobiles to utilize it.

Representative BROWN. I would agree with that except we already have a lot of those on the road and the objective might be accomplished in that way, too.

Mr. BURNS. I join you in your proposal for a lower speed limit, not only to conserve gasoline but also to conserve human life, which is even more important.

Representative BROWN. I will ask you to cosponsor that within maybe the next few days.

One final question. You said these arrangements have their advantages; that is, central bank intervention, the impact on exchange markets of speculative purchases and sales of currencies can be deflected in rate movements that eventually will be self-limiting. Mr Friedman says he expects the speculators eventually to get caught in a situation where we have overvalued gold and that point may not be too far off and that it is in effect self-regulating. Is this what you are suggesting and could you predict for us or offer us some word of encouragement at least about the future of the value of the dollar in relation to gold and other currencies?

Mr. BURNS. Well, I believe that the dollar is basically a very strong currency. Those who have gone short on the dollar will rue the day. But in the meantime, many of us may get punished before the speculators are.

Representative BROWN. Thank you, Mr. Chairman.

Chairman REUSS. Senator Percy.

Senator PERCY. Mr. Burns, I was very sorry not to have been here during the course of your testimony and to have missed the very learned questioning of our chairman. We had a markup this morning in the special committee formed in the Government Operations Committee to create a new structure of budgetary control in the Congress. I would like to first ask your judgment as to the importance in your opinion in insuring more confidence in the dollar abroad, particularly if the Congress itself resolves to once and for all face up to the fiscal responsibility. You must have fiscal responsibilities here if you have the constitutional authority for taxing and spending. We must exercise a good deal of discipline. We must have a new procedure for requiring Congress to impose limitations on itself and restraints, and very early in the game. We must match our outgo with our income and make it exceedingly difficult to exceed our own ceilings. Do you feel this would be an important forward step in reassuring the world that we do intend to and are serious about controlling inflation and Federal expenditures to the extent that they do contribute to inflation?

Mr. BURNS. Senator, if the Congress passes legislation along these lines promptly, I cannot think of anything that would have a more far-reaching effect on financial opinion throughout the world.

Senator PERCY. There are two schools of thought in our subcommittee and possibly in the full Committee on Government Operations. One school says it is unrealistic to take to the floor of the Senate or House a procedure which would be too limiting. In effect, though they do not use these words; they advocate that the ceiling should be a rubber ceiling which, as circumstances come along, you can continue to exceed. Do you think, that if at this stage after all these deliberations and resolutions and rhetoric, that if we adopted something which on the face of it was not really meaningful, that we would really accomplish anything?

Mr. BURNS. I go further. I would say that if the Congress passed legislation under which we would have a rubbery ceiling, great damage would be done because credibility would be destroyed. Now there is still hope.

Senator PERCY. I appreciate that comment. I would like to turn to the question of gold because of our chairman's interest in the subject. Possibly he has already asked as to what role you see for gold and whether or not there should always be the possibility that we might at some time sell gold. How do you look on that possibility as tempering the speculative mood of the present gold market?

There seems to be a feel on the part of the speculators that price can only go up and there never would be conditions under which they might take a loss. This has been true for some time now.

Mr. BURNS. I would look favorably to that possibility.

Senator PERCY. Considering the thin market that exists, if we did decide as a matter of policy to sell some gold, what would be the effect on the market price of gold if it looked like we were not only willing to sell now, but might continue to adopt that policy in order to control undue speculation?

Mr. BURNS. Well, I would expect that in that case the madness that has ruled in the gold market would definitely subside. I would only add that our present arrangements on gold are part of an international agreement and I do not think we ought to act unilaterally.

Senator PERCY. I wonder if you already commented on the dip in May in our trade surplus, as to whether this is entirely attributable to the high level of agricultural exports. I think in your testimony you get into some detail and you do foresee overall, on an annual basis, a substantial improvement. But is the May drop in our trade balance a temporary phenomenon, or just what?

Mr. BURNS. The figures on imports and exports are quite erratic on a monthly basis. I do not attach any special significance to that. As I read the figures, going back to the fourth quarter of 1972, we had a trade deficit of $7 billion on an annual rate basis. That was reduced to $3.8 billion in the first quarter. If you take the months of April and May combined, the trade deficit was $1.2 or $1.3 billion. So we are definitely making progress.

Now, the specific figures for May are not easy to interpret. There was quite a jump and it was rather widespread. I have not analyzed the figures such as yet. Actually, all the information I need is not available but I suspect a large part of the increase in the dollar value of our imports in May was due to the runup in the prices of internationally traded foodstuffs and raw materials. Even so, looking at the figures, we also had a substantial increase in imports of automotive equipment from Canada. It is very hard to explain.

On the other hand, there was a sharp decrease in April, which again is hard to explain. I think you have to average several months together to discover the underlying trend.

I was rather surprised that exchange traders took this recent increase in imports as a very bad sign. I think exchange traders are influenced unduly by day-to-day developments.

Senator PERCY. In your testimony you give your own impressions, the most important factor was the accumulating evidence that moderate success which the United States has achieved in curbing inflation during 1972 is eroding. Is this the largest contributing factor to further depreciation of the dollar?

I think this does cause tremendous distortions in the economy when people feel it is better to have things than dollars. It gives every incentive for them to expand their purchases at a very time when we are running a boom economy rate. I would like to get the benefit of your views extended and expanded somewhat as expressed before on what can be done through capital investment to reduce the rate of inflation through improving the productivity in this country, absorbing wage increases through increased output, holding firm on unit costs of production, and continuing to earn our favorable exchange position through the value of the product that we offer in foreign markets as against just devaluation of the dollar which is somewhat artificial.

You have proposed an increase on a sliding scale on the investment tax credit up to 15 percent. Taking into account in this boom period, you suggest it possibly should be reduced to, say, 3 percent by edict of the President, subject to reversal by the Congress. Would you care to expand on the importance you attach to a proposal of this kind as related to improving our trade balance and working at the fundamentals of inflation rather than the cosmetics of it?

Mr. BURNS. Well, over the long run, thinking of fundamentals as you are, I think we need to expand our investment substantially. Over the long run, I think the rate of profit also will have to go up. Otherwise, our economy will suffer.

On the other hand, over the short run I would much prefer to see the pace of investment expenditures slow down. If it does not, the present rate of expansion simply will not be sustained and then we will have another decline in business investment which will carry much of the rest of the economy with it. So a more even rate of investment, but at a higher level, is, I think, the objective that we ought to seek—both in the interest of greater economic stability and in the interest of winning better control over the inflation problem.

Senator PERCY. Well, I concur with you and I think we have a lot of probing to do and a lot of convincing to do both in the labor and the business community. It is an exciting new concept and something that I certainly feel we need much better public understanding on as well as congressional understanding on and I commend you for advancing this thought and suggestion.

The other areas that we would lke your judgment on. We had five heads of financial institutions. I asked them as to the effect of multinational corporations on the value of the dollar abroad and whether in their judgment, multinationals were speculating in order to earn profits on the dollar or whether they were just carrying on fairly normal transactions to hedge against the eventuality that a change in exchange rates may have a very adverse effect upon planned earnings, and so forth. Would you care to give us your comments as to whether a major role is played by multinationals in the speculative market that exists for the dollar?

Mr. BURNS. My impression is business firms by and large have not been speculating. On the other hand, I should add that we need more factual information on that of a verified character than we as yet have. There is a study that the Department of Commerce and Department of the Treasury are now engaged in which should throw some light on that question. But I have definitely the impression that speculation has come from other quarters.

Senator PERCY. I am glad to have that confirmed and certainly the heads of these five great financial institutions would not try to mislead this committee. They could not name a single instance, thousands of companies with which they deal, where speculation was there just to make and show profit on changes in money rates. I mentioned and pointed out as the head of a modest sized multinational when I anticipated there would be devaluation of the pound, we bought futures in sterling but right precisely to what we anticipated were our expected earnings in sterling because devaluation would have destroyed programs that we planned for capital investment, et cetera. We were just trying to preserve and protect the earning structure we had. I considered nothing immoral or wrong about that. It was prudent business. I did not look on it as speculation. We were just buying an insurance policy.

I think that practice if adhered to by multinationals is justifiable but to go beyond that would certainly not be justifiable and we intend to see that we accumulate what evidence we can to discourage that if we can. I think multinationals today have a rather bad name which we can find no evidence for but if there is evidence we certainly would appreciate having it.

Mr. BURNS. I have not seen any of it, and I have talked to any number of businessmen in this country and abroad about this problem, and have talked with bankers, foreign as well as American, and they

have been unable to supply evidence. On the other hand, there has been a good deal of speculation that has come from other quarters.

Senator PERCY. Lastly, a question that I will certainly understand if you do not want to address yourself to it, but there seems to be no hesitancy on the part of the heads of these financial institutions to discuss it. It followed a statement that I had made that when you get down to it, financial and fiscal and monetary policy is more an art than a science. You cannot slide rule everything in this field, that many intangibles come into it. They did testify that in their judgment, Watergate had had an adverse effect and the sooner we get it behind us and clean it up the better it is going to be.

Could you tell us to what degree, if any, in your judgment, this phenomenon called Watergate has had an unsettling effect on the dollar and is an intangible which has no relationship to whether or not this economy is strong, whether we do have a manageable and controllable budget, whether our productivity is being held in check, whether we have inflation at a rate higher than we want but still lower than any of the countries whose currencies have strengthened and ours has weakened. Does Watergate have an effect?

Mr. BURNS. Watergate is frequently mentioned by financial writers, and frequently mentioned by financiers. On the other hand, when I have probed the thinking of financiers, I have found that they are fundamentally worried about other things and that Watergate has little connection with their real worries; namely, the direction of our overall economic policy, the rate of inflation in this country, the rate of spending in this country, the failure to do something about the inflation problem through the tax side. When I probe their thinking, I have found that these are their basic concerns, though they sometimes will say that Watergate is tending to immobilize the Government.

Well, all that is a matter of judgment. As far as I can see, the Government is functioning. We had two appointments to make at the Federal Reserve and those appointments went through with exemplary speed. And the Congress clearly is functioning. You are in a better position to judge whether or not Watergate is slowing down the activity of the Congress.

Senator PERCY. Well, I think in effect, what you are saying is that it is important that we do carry on the functions of Government, that we do give every appearance and action that this is not going to divert so much attention from those of us in the Congress and executive branch of the Government that we do not make those decisions swiftly and decisively that affect our economy, our well-being as a Nation, and our image abroad. I can assure you, Dr. Burns, that those of us who have discussed it here feel very strongly about that. I feel a sense of greater urgency here to make decisions, to get things done, to carry on the work of Government, and I have urged the executive branch to do likewise. To the extent that Watergate does take the time of some members of the executive branch we regret it because it does take away the decisionmaking process. I think we have a tremendous obligation.

You can do an awful lot of things in the Federal Reserve. The Treasury can do a lot of things, the private sector of the economy can do a lot of things, but still we are dependent to a degree upon governmental decisionmaking and what phase IV turns out to be. What

we announce at the end of the present freeze is terribly important and I hope all of us recognize the importance of that address on our shoulders. But from what I have seen there is very little television watching around here during the day. I am not saying on some educational channels it is not watched late at night by myself and my colleagues. But there is a will to keep this government working here and anybody who speculates that we do not have a functioning government is speculating in the wrong way. I feel such speculators are selling short the American economy today with these low prices on the stock exchange. I have never seen a time when I was more confident that almost literally across the board you have got unparalleled opportunities for purchase right now in many companies. Business is growing at a very healthy, strong rate now. If anything, perhaps too the rate is too strong.

Mr. BURNS. Well, I can only add these two observations. As far as the Federal Reserve is concerned, Watergate has absolutely no influence on our operations. In other departments I deal with, the decisions are made with customary promptness or customary delays—you can define it as you will. As far as businessmen are concerned, the Watergate is discussed very extensively, but I have yet to find a businessman—I have talked to many of them—who, because of Watergate, has changed his business plans one iota. I am less sure about financial markets. Opinion there changes swiftly, and is much influenced by rumor and the kinds of stories that appear in the daily newspapers.

Senator PERCY. Mr. Burns, we thank you very much indeed, for your testimony, which is very valuable indeed. The chairman has asked me to express his regret that he had to go to the floor of the House for a rollcall there but we are always happy to have you here. You make an invaluable contribution. I, for one, am glad to have you as the head of the Federal Reserve. The subcommittee stands adjourned.

Mr. BURNS. Thank you, Senator.

[Whereupon, at 12:20 p.m., the subcommittee adjourned, subject to the call of the Chair.]

APPENDIX

Inflation and the International Monetary System

(Paper presented by Otmar Emminger, Deputy Governor, Deutsche Bundesbank, Frankfurt, Federal Republic of Germany, at the 10th lecture meeting of the Per Jacobsson Foundation in Basle, Switzerland, June 16, 1973)

I. THE BRETTON WOODS SYSTEM BROKE DOWN—OWING TO ITS INFLATIONARY IMPLICATIONS

Three years ago, M. Pierre-Paul Schweitzer, the Managing Director of the International Monetary Fund, said in an address given at an International Financial Conference in Geneva: "Looking back at the 1960's, we can say that the international monetary system has been through something of an ordeal by fire. It survived that ordeal and has emerged with improved foundations." The "ordeal" he was speaking of was a series of crises around the pound sterling from 1964 to 1968 and the gold crisis of 1968. How then should we, in comparison, characterise what has happened since 1970 in the international monetary sphere? In order to keep the right proportion between the two periods, we would have to say: the international monetary system has been through an ordeal by holocaust. And as of now, it has not yet emerged with improved foundations—although we fervently hope that crisis will be converted into opportunity, and that an improved system will finally emerge.

It has always astonished me that one of the crucial points behind the breakdown of the old system seems to have been so little understood. Most people—including many monetary experts—seem to believe that the main problem was the unrest in the foreign exchange markets produced by distrust in parities and disorderly capital flows. Some people—economists as well as politicians—have drawn the conclusion that, in order to prevent such disorders in future, one should create very large facilities for financing such capital flows: unlimited financing through the IMF was advocated in the influential "New York Times", and special automatic credit facilities in the Fund have indeed been proposed for such a purpose in the framework of the discussion on international monetary reform; European politicians have been suggesting large automatic financing facilities through the new European Monetary Fund for similar purposes. All this misses the real point. The previous regime did not break down because of the unrest in exchange markets. It has also rightly been pointed out that in spite of the currency disorders world trade has continued to expand by leaps and bounds; and in spite of a rush of controls against disequilibrating capital flows even international investment, in particular direct investment, is flourishing. Nor did the system break down because of a lack of financing facilities—European central banks had no lack of their own currency with which to buy up incoming dollars. It broke down because the limit of tolerance for the inflationary effect of such currency inflows had been reached. New financial facilities (or a "re-cycling" of short-term capital flows) would be no remedy for that but would just increase the potential for more inflationary capital flows.

So the previous system broke down because of its inflationary implications. This is worth stressing. One should take note of this fact in the present reform discussions, where so many objectives are being pursued but where sometimes the need for providing better protection against inflation is pushed into the background.[1]

The relationship between the world monetary system and inflation has not always been so unambiguous as during the recent currency crises. True, the system, and particularly its central part, the de-facto dollar standard, has been

[1] After last year's Annual Meeting of the IMF Governors in Washington (September 1972), which concerned itself mainly with world monetary reform, the London "Economist" wrote: "But there was a horrible silence on world inflation." In essence this was true, although the problem was mentioned by a few Governors.

criticized by eminent experts as a "perfect inflation machine". But on the other hand, in the first two decades after Bretton Woods the prevalent view, at least in the United States and Britain, was that the world monetary system had a "deflationary bias". Two reasons were advanced for that view: a one-sided adjustment process and an inadequate system of liquidity creation. It was assumed that a system of fixed parities exerted pressures for adjustment on deficit countries but hardly on surplus countries. This was the suspicion and fear which Keynes had at the Bretton Woods Conference (he feared a "contractionist pressure on world trade"). As time went on, this fear was transmitted to the United States, and it has lingered on there to this day. It has found its reflection in the American proposals for monetary reform whose main intention is to put more adjustment pressure on surplus countries.

A second reason for fearing a deflationary bias was the view of the Triffin school that a system which relied mainly on the creation of dollar liabilities for its supply of additional reserves would inevitably bump against a ceiling and would over time lead to a shortage of international liquidity; the more extreme school even predicted an international "liquidity collapse".

This dual fear of built-in deflation has been belied by actual developments. They have demonstrated that first, the mechanism of adjustment to payments imbalances has not resulted in a deflationary but in an inflationary bias of the system, and second, instead of experiencing a "liquidity shortage" we have been exposed to a colossal liquidity explosion.

Prof. (Lord) Robbins, one of the participants at the Bretton Woods Conference of 1944, has recently narrated the story how the well-known British Treasury expert R. G. Hawtrey had sent a note to the British delegation at Bretton Woods which said in essence "What's all this talk about deflation after the War? The problem is not going to be deflation; it's going to be inflation". His lonely foresight was not taken seriously at Bretton Woods and no adequate defences against inflation were built into the system.

Now the question is: Was the international monetary system just defenceless against overpowering forces of inflation emanating from the major countries? Or has the system itself contributed to, or re-inforced the inflationary tendencies by its own institutions?

II. SOME EXPLANATIONS OF WORLD-WIDE INFLATION

Let us first take a glance at the phenomenon of world-wide inflation. The evolution over recent years points strongly to some common cause or causes of world inflation. Indeed, what is particularly striking and ominous in the world economy of today is not only the *progressive strengthening* but in particular the *universal character* of inflationary forces in the industrial countries. Among the OECD countries the average weighted price increase—measured in terms of consumer prices—was 2.4 percent p.a. in the second half of the fifties, 2.6 percent p.a. in the first half of the sixties, 4.2 percent p.a. in the second half of the sixties, 5.3 percent p.a. in the three years 1970 to 1972, and is estimated for 1973 to be over 6 percent (and in the OECD countries outside the U.S. even between 7 and 9 percent). Nearly all industrial countries, apart from the United States, seem to be marching at present "in step" at a rate of inflation of 7 percent or more.

Economists have various explanations at hand for the almost universal character of inflation. According to some, there has been a simultaneous *change in the socio-economic environment* in most industrial countries which has nearly everywhere led to excessive claims on the economy, be it from overambitious government (and government-subsidized) spending or excessive wage settlements, or in most cases from both. This has resulted in many countries in an irrepressible combination of demand and cost-push inflation together with a dangerous escalation of inflationary expectations. There can be no doubt that the universal propagation of price inflation has been facilitated by the transmission mechanism of fixed parities. But this contribution, in the view of these observers, has not been a primary but only a supplementary source of world-wide inflation. Such an explanation raises several questions: Where is the place of monetary policy in this whole argument? Why has monetary policy become so permissive universally? And what has happened to the balance-of-payments discipline of fixed parities? Were not fixed parities supposed to put a brake—perhaps the only effective, because exogenous brake—on spendthrift governments and excessive wage settlements? [2]

[2] Even as late as 1971, Prof. Harry Johnson said in a panel discussion on "World Inflation": "The major discipline imposed for the control of inflation in individual countries is the fear of balance-of-payments deficits." He thus reiterated an argument put forward very forcefully by Prof. Jacob Viner twenty years earlier.

Other observers emphasize the monetary side and argue: As we have inflation on a world-wide scale, we must have had excessive money creation on a international scale. So we should perhaps look toward the *excessive expansion of international liquidity* as the really "universal" scapegoat for the loosening of the monetary reins. But how can we explain the fact that the dangerous acceleration of world-wide price inflation began in the second half of the sixties, at a time when the creation of international reserves was still very modest—more modest, indeed, than in the first half of the sixties? [3] The connection between "international liquidity", in the sense of the supply of world reserves, and domestic money creation and inflation is not so simple and direct, although there can be no doubt that the "liquidity explosion" after 1970 has had something to do with the subsequent further acceleration of price inflation.

Other experts again explain world-wide inflation by simply pointing to *demand and price developments in the United States*. In their view developments in the largest economy of the western world will decisively influence, at least in a system of fixed parities and unlimited dollar financing, the development of money supply and prices elsewhere. As one authority on international monetary affairs put it: "Inflation in the United States determines the pace of inflation abroad." [4] Or as Milton Friedman used to say: "Under a dollar-based system with fixed exchange rates, the monetary policies of the world will be determined by the monetary policy of the Federal Reserve in Washington." But here again doubts arise when we look more closely at the historical facts. It is true that in the period of Vietnam escalation from 1966 through 1970 the United States economy was leading the inflationary lockstep of the industrial world. But from 1971 to 1973 there followed a period when money creation as well as price and cost inflation have been at significantly lower rates in the United States than in the rest of the industrial world. Why has this recent lower rate of U.S. inflation not had any dampening effect whatsoever on world price inflation, although its retarding effects in terms of other currencies were strongly re-inforced by the devaluation of the dollar? [5] And looking over a longer period, in the twenty years from 1953 to 1973 U.S. prices increased less than those of all other major industrial countries, even apart from changes in relative currency values. Why has this not acted as a brake on inflation elsewhere? And have not other countries complained again and again that they were importing inflation from the United States even in periods when inflation there was much lower than elsewhere?

III. THE CONTRIBUTION OF THE INTERNATIONAL MONETARY SYSTEM TO WORLD INFLATION

It appears that none of these mono-causal explanations is fully convincing, although each of them points to one probable ingredient of the complicated process of world inflation.

What we are interested in here is *what contribution the international monetary system has made to this process*. Has the fault been with deficient national policies in major countries whose inflationary effects were then propogated throughout the world by the transmission mechanism of fixed parities? Or have there been intrinsic deficiencies in our system? At the IMF Meeting in Vienna in 1961, the Governor of the Dutch central bank, Holtrop, declared: "In my opinion, our present problems are not due to any inherent deficiency in our institutional setup. Therefore, we cannot hope to solve them by changes in our institutions, but only by changes in our policies." No doubt: had all the major countries pursued perfect policies and fully lived up to the rules of the game, the system—or for that matter: *any* system—would probably have worked well. But the real question is: how did the international monetary system, as it evolved from the Bretton Woods Agreement, face up to the realities of the post-war era, including those arising from big structural changes in the world economy? And in particular: has it been a positive or negative factor in the fight against inflation?

My answer to these questions is: *The international monetary system has not only yielded in too permissive a way to inflationary forces which emanated from domestic inflation in important countries, but has also been generating inflation on its own.*

[3] In the years 1965 through 1969 the average annual increase of gold and foreign exchange reserves was only 2.0%, as against 3.6% in the period from 1960 through 1964.

[4] Gottfried Haberler and Thomas D. Willett, A Strategy for U.S. Balance of Payments Policy, Washington 1971, p. 20. (Haberler gives some reasons for this American price dominance, i.e. for an asymmetrical relationship between prices in the U.S. and in other countries.) Similarly Prof. Harry Johnson: "U.S. prices tend to serve as an anchor to everybody else's."

[5] From the beginning of 1971 through March 1973, U.S. prices in terms of DMarks have fallen by 16% (consumer prices) and 12% (export unit values, January 1971 to February 1973).

Let me briefly enumerate the main developments that have contributed to this result.

1. The transmission mechanism of fixed parities has worked more and more as a *one-way street* only, namely in the direction of inflation. The much-vaunted discipline of the balance of payments did not work. This has been due mainly to the increasing resistence—or sheer inability—on the part of deficit countries to adjust to external deficits by domestic stabilisation, let alone even the mildest form of deflation. The most important, but by no means the only example of this asymmetric adjustment process has been the deficit of the United States which as the reserve center of the system had practically unlimited external financing available until the system broke down. Thus, while academic economists were still theorizing about the presumed "deflationary bias" of the adjustment process, in actual practice its bias was in the opposite direction.

2. The mechanism of rigid parities transmitted not only inflation from one country to another, but converted even non-inflationary structural deficits, like that of the United States during part of the post-war period, into a source of inflation for the rest of the world. Most industrial countries defended their own parity by intervention against the U.S. dollar, as the dollar had become the intervention and reserve currency of the world. Thus, *in the name of supporting the fixed parities system* they allowed a large structural imbalance to build up in the world economy, with the further consequences of imported inflation and excessive liquidity creation.

3. Over the last ten years, *volatile capital flows* have assumed dimensions never dreamt of before. In a system of fixed, but no longer trusted parities they have magnified the pressure of imported inflation in the recipient countries, and they have undercut anti-inflationary policies in some countries which formerly played a crucial disciplinary role as "islands of stability".

4. There has been an inherent tendency in the system to create *too much international liquidity* in the form of the excessive accumulation of currency reserves. The main source of this excess liquidity was, of course, the protracted payments deficit of the United States, the reserve center of the system. But there have also been other sources of uncontrolled liquidity creation, such as a trend towards "diversification" of exchange reserves into currencies other than the dollar as well as money creation in the Euromoney market.

This combination of trends and forces in the world monetary system, namely a one-sided process of balance-of-payments adjustment, a rigid parity system based on a structurally weakening dollar, destabilising capital flows, and uncontrolled expansion of international liquidity, has proved to be about the most inflationary mixture imaginable. It has helped to pervert fixed parities from being an instrument of discipline on deficit countries to one forcing monetary debauchery on surplus countries.

I think it is worthwhile analysing some of these processes a little further so as to be able to draw lessons for the future.

IV. THE DEGENERATION OF THE FIXED PARITIES SYSTEM

A system of fixed parities can only work without too much inflation if there is a certain balance in the adjustment process. Of course, nobody would dare to expect from a decifit country even the mildest form of deflation. But a deficit country should at least contribute to adjustment by eliminating domestic inflation. During the last ten to fifteen years, there has been no major international disequilibrium where a deficit country achieved real stability of costs and prices over any length of time—with the exception of the United States from 1960 to 1965.

Already in 1964 the IMF deflated the fable of the disproportionate burden of adjustment on deficit countries and the consequent deflationary bias of the world monetary system. It said in its Annual Report of that year (Annual Report for 1964, page 28): "In modern societies, actual reductions in wage and salary levels are regarded as acceptable only in the most unusual conditions. . . . On the other hand, few countries can completely resist cost and price increases when the underlying pressures for upward adjustment are strong. The result is that international adjustment through changes in relative costs and prices typically involves more upward adjustment in surplus countries than downward adjustment in deficit countries." The Fund commented this inflationary asymmetry of the adjustment process with approval (IMF Annual Report for 1964, page 4: "The international monetary system has been able to meet the challenges to which it has been exposed.")

This asymmetric adjustment process was strongly supported by *permissiveness in the financing* of balance-of-payments deficits. The British case during the sixties is a good case in point. During the years 1964 through 1968, the United Kingdom received no less than 8 billion dollars worth of short- and medium-term currency loans from abroad to finance its deficits, that is to say, nearly three times the amount of its own official reserves at the beginning of the deficit period. For the group of industrial countries that provided this financing either directly or through the IMF (and GAB), this meant corresponding money creation through their central banks. For some countries their share in this inflationary financing of the 8 billion dollars currency loans represented a significant amount in terms of their own monetary base. A few years later, such amounts were, of course, completely dwarfed by the inflationary central bank financing of huge U.S. deficits through unlimited support of a fixed dollar parity by the other industrial countries.

It was indeed the exacerbation of the *dollar problem* that finally perverted the regime of fixed parities and turned it into a machinery of inflation. The dollar problem involved much more than merely transmitting U.S. domestic inflation to other industrial countries via the turntable of fixed exchange rates. True, from 1965 to 1970 this process also played its part. During that period the U.S. rate of price and cost inflation was higher than in the OECD countries and this contributed to the deterioration of the competitive position of the U.S. in the world as well as to world inflation. But taking the last twenty years together, i.e. from 1953 to 1973, the United States could boast the lowest rate of price inflation—whether measured in terms of consumer or GNP prices— of all the major industrial countries. There was a memorable episode at the Tokyo Meeting of the IMF in 1964. When some European finance ministers complained about the inflation their countries were importing from the U.S., the then U.S. Secretary of the Treasury (Douglas Dillon) retorted: "There is certainly no inflation in the United States so we have no inflation to export."

But the U.S. was in fact exporting inflation even at that time; not as a result of any domestic price inflation, but through external deficits which were mainly due to two *structural trends*. an enormous "structural" upswing in its capital exports and a structural deterioration in its trade position which in 1964 was not yet clearly discernible, but came to the surface near the end of the sixties). Europe and Japan had rebuilt their economies and were beginning to catch up with U.S. industrial productivity. They had also begun to discover, and develop, the huge American market for their products. These developments contributed to a gradual relative over-valuation of the dollar in relation to some other currencies. Secondly, American corporations at the end of the fifties began to discover the vast investment opportunities abroad; prompted by lower wage costs abroad and assisted by abundant and relatively cheap financing facilities, they began to buy up companies or set up foreign subsidiaries in a grand style. In this way part of the U.S. export base was exported abroad, which helped to accelerate the structural deterioration of U.S. trade. The high capital exports which by far surpassed the U.S. net exports of goods and services (i.e. of "real" capital), were an important vehicle for inducing inflation in the recipient countries. These structural factors, and a reverse structural factor in the foreign trade of Japan, were more important than the much-discussed "inflation differentials" in causing the protracted payments disequilibrium of the United States and the consequent imported inflation in Europe and Japan.

In essence, it was a simple problem. At the beginning of the 1950s the per capita income in the United States was about three times the per capita income in Europe and even higher in relation to Japan (at the then existing rates of exchange). With the catching-up of European and Japanese industries such a large discrepancy in relative income levels could not be maintained. This put the regime of fixed parities between the dollar and the relevant other currencies under a great strain. Even with complete cost and price stability in the United States, if Europe and Japan wanted to maintain their fixed dollar parities, they would have had to accept an inflationary upward adjustment in their income and price levels. This catching-up process of income levels was made even more difficult when nominal incomes and costs in the United States began to move up rapidly in the second half of the sixties. Even between the U.S. and Germany—which had its currency upvalued relative to the dollar between 1961 and 1973 through its own or through American action, by no less than 49%—this process of adjusting relative wage and income levels took a long time. In 1960, the average income per capita in Germany was still only 44% of that in America. In 1970 the relationship had risen to 61%. In 1973 it has reached about 85% (calculated at current rates of

exchange); this seems now to correspond to the relative levels of national productivity. The structural adjustment between the major economies and currencies of the world to the new realities of the seventies—a "normalisation" process after the previous period of absolute predominance of American industrial power—has been a once-for-all process of historic dimensions. It strained the system of fixed parities beyond breaking point.

These structural considerations seem to me to give a better clue to the underlying problems of the post-war adjustment process than the wide-spread American view that European countries and Japan deliberately pursued "mercantilist" policies directed at generating persistent surpluses. Some American critics have persuaded themselves that the Europeans and Japanese have been suffering from a deep-seated "surplus syndrome". It is true that the structural process of normalization would have required either even more inflation in Europe or a near-continuous process of upvaluation of some European currencies on the one hand, or devaluation of the dollar on the other. In view of the difficulties as well as the uniqueness of such a structural adjustment process, it is not surprising that each partner to this process usually attaches most blame to the partners on the opposite side.

The overvaluation of the dollar which came about in the process of post-war normalization is sometimes ascribed to an innate *"devaluation bias"* of the previous dollar-centered system. Indeed, up to 1971 many dozens of currencies were devalued, but only a few were upvalued vis-a-vis the dollar. This fact, however, is not in itself proof of an overevaluation of the dollar, as most of the devaluations resulted from high domestic inflation in the respective countries. It is a different thing that the system may have suffered from an "anti-upvaluation bias", that is to say that a number of industrial countries resisted for too long the inevitable realignment of their currencies in relation to the dollar (or, that for too long it was considered that the dollar could not be devalued).

It was fatal for the system that the currency which had to undergo this structural adjustment in relation to other important currencies, namely the dollar, happened to be the *main reserve and intervention currency* of the world. In deference to, and in defense of the system of fixed parities the other countries supported the parity of the U.S. dollar by accumulating enormous amounts of dollars. Thus the structural imbalance was prolonged, a large "overhang" of liquid dollars was created in foreign hands and the economic climate in the world became increasingly inflationary. Finally, the impact of this situation on confidence in the leading currency has temporarily made the whole international currency system hostage to disruptive speculative movements of funds and large-scale distortions of the terms of payments in foreign trade, movements which not only have transmitted inflation from one country to the other, but which in a fixed parity system were *outright sources of new inflation* in the recipient countries.

However, the gradual shift of fixed parities from being a stabilising to being a destabilising force has not been limited to the effects of a weakening dollar. It has been a more general process in which some features of the monetary system have played their part. These were on the one hand the overly rigid application of the parity system, and on the other hand the permissive reserve and financing system aided and abetted by Eurocurrency markets and other subsidiary liquidity systems.

As a consequence of these combined factors all the major payments disequilibria of the last twenty years—whether they were due to inflationary internal policies or to changes in the structural position of deficit countries—were in the end resolved through a further turn in the inflationary spiral in the world economy (or in extreme cases by altering exchange values), and not in one single case by real deflation of prices or incomes in the deficit countries. Thus we have here a close parallel to what has evolved in domestic economic policies; here, too, there is a growing tendency to resolve economic or social conflicts of all kinds by papering them over with inflationary settlements. Inflation as a general instrument for "pacification", for resolving conflicts in the domestic as well as in the international field!

V. WHAT IS LEFT OF THE BALANCE-OF-PAYMENTS DISCIPLINE

Let me quote a few historic instances which illustrate the decline and fall of fixed parities as a disciplinary force.

In 1969, the famous doctrine of "benign neglect" appeared on the American scene. Although never officially adopted by the American authorities, it reflected fairly well the prevailing American attitude that domestic monetary and fiscal policies should not be constrained to any significant extent by the requirements of external balance and the maintenance of a fixed dollar parity. This doctrine was

dropped in August 1971 with the adoption of a policy to rehabilitate the external strength of the dollar, not, however, in favour of adjusting internal demand management to balance-of-payments requirements, but in favour of casting the dollar parity adrift.

In the spring of 1972, the British Chancellor of the Exchequer made the following statement in the House of Commons: "I am sure that all members will agree that the lesson of the international balance-of-payments upsets of the last few years is that it is neither necessary nor desirable to distort domestic economies to an unacceptable extent in order to maintain unrealistic exchange rates, whether they are too high or too low." The view as to what constitutes an "unacceptable extent" has changed greatly over the last ten years. And British experience in the summer of 1972 showed that whether an exchange rate should be considered "unrealistic" or defensible was in the last instance not decided by the authorities but by market forces. At any event, this statement represents a further decisive step away from accepting fixed parities as a disciplinary force.

The concluding word on this issue should be left to Prof. Arthur Burns, the Chairman of the Federal Reserve Board. In an important statement at an International Bankers' Conference in Montreal in May 1972, he gave the principle of autonomy with regard to external constraints the following general formulation: "The international monetary system will have to respect the need for substantial autonomy of domestic economic policies . . . No country . . . should have to accept sizeable increases in unemployment in order to reduce its deficits. Nor should a surplus country have . . . (to accept) high rates of inflation. This is of course, only a description of the existing realities—but it illustrates well the downgrading of fixed parities on the scale of priorities, as compared with domestic policy goals.

As a reflection of this shift, "balance-of-payments discipline" has nowadays assumed a different meaning from what it meant fifteen or twenty years ago. The American proposals for reform of the balance-of-payments adjustment process (reserve movements as "objective indicators for adjustment") aim at securing a more timely and more symmetrical balance-of-payments adjustment. This sought-after new symmetry does not exclude adjustment measures in the domestic field, such as monetary or fiscal action, but it is aimed particulary at establishing a rule for the *timely adjustment of exchange rates* to whatever external situation has been created by domestic policies. This "discipline of exchange-rate adjustment" is a far cry from the discipline of internal adjustment under the classical gold standard and the original system of fixed parities.[6]

VI. DISEQUILIBRATING CAPITAL FLOWS AS THE "VILLAIN OF THE PIECE"

The world payments situation over the last few years has to a large extent been dominated by abnormal capital movements. Let us take some outstanding examples. In the *United States*, official reserve transactions from the beginning of 1970 through March 1973 resulted in a total deficit of about 62 billion dollars.[7] Of this total, about 25 billion was due to the basic deficit (current and long-term capital account) and the remaining far greater part to short-term capital flows and unrecorded movements.[8] Or take the example of *Germany;* during the same period from 1970 through March 1973, total foreign exchange inflows into Germany amounted to 78 billion DMark, of which only between 5 and 10 billion DMark, or about one-tenth, can be accounted for by a surplus on current account, while nearly all the rest can be qualified as abnormal capital imports.[9] In the five crisis weeks from the end of January to the first of March 1973, nearly 10 billion dollars, or three times the estimated deficit on basic account of the first quarter 1973, were moved out of the United States into other countries, while the main recipient countries had to take in an estimated 12 billion dollars-the difference being accounted for by reserve creation via diversification of exchange reserves and redepositing funds in the Eurocurrency markets. About two-thirds of the total went into the DMark. A third example is the sterling crisis in the summer of 1972:

[6] Cf. Marina Whitman, Member of U.S. Council of Economic Advisers, in a speech in New York on October 27, 1972: "And, of course, the whole U.S. proposal is predicated on the assumption that no country is going to subordinate its domestic economic goals to balance of payments considerations as Great Britain did, for example, in the mid-1920's and throughout much of the period since World War II. *I think that is a closed issue.*"

[7] Excluding SDR allocations.

[8] Some part of the long-term capital outflows, especially in 1971, should also be counted among the "abnormal" capital flows.

[9] As Germany was normally a net capital exporter up to 1969, the "abnormal" inflow may even have been higher than the *net* capital import.

current account of the *United Kingdom* in 1972 was still in slight surplus, while big speculative capital outflows forced the pound off its fixed parity. In all these cases, if exchange-rate measures, including floating, had not been resorted to the disruptive capital flows would have been far larger still.

Several conclusions can be drawn from these experiences: First, even a moderate deterioration in the current or basic balance of payments of a major country can have a big leverage because it can set very large capital flows in motion. Second, capital movements sometimes anticipate an expected future deterioration in a massive way and may thus force the hands of the authorities (as was shown in both the British and the Italian case).

Disruptive capital flows have become a *major factor—the "villian of the piece"—on the international monetary scene.* It is obvious that they can have an enormous inflationary impact on the whole world monetary system. The losing country will hardly ever allow these outflows to have a significant contractive influence. In the recipient country the central bank has to finance them by creating additional central bank money. Thus making funds of the deficit country which are easily replaceable are converted into high-powered money in the recipient country the primary effect of such inflows on the domestic money system of the recipient country should be measured not by their relation to the total domestic money supply but to the domestic "monetary base". For several recipient countries the inflows meant the complete loss of control over their money supply.

In *Germany*, monetary policy was paralysed by such inflows—or the permanent threat of them—practically from the autumn of 1968 through March 1973, with the exception of a few months after the upvaluation of October 1969 and a few months of DMark floating in 1971. The inflows in the three years from spring 1970 to spring 1973 had a tremendous impact on the "monetary base" of the country, despite all efforts at sterilising them; and they more than accounted for the total increase in the domestic money supply during this period. In *Switzerland*, the inflow of a few billion dollars in the summer of 1971 sufficed to paralyse monetary policy for nearly two years. Thus two key countries were put out of action in their fight against inflation and could no longer play their former role as "islands of stability" in, and stabilisers of the European economy. The OECD has repeatedly pointed out in its reports that the disappearance of such "islands of stability" with their disciplinary effect on their partner countries was an important factor in the general acceleration of inflation in Europe since the end of the sixties. For the countries directly concerned, the undermining of their fight against inflation through the constant threat of destabilising inflows and serious economic and social consequences.

Thus we have witnessed in recent years two different kinds of imported inflation under the regime of fixed parities. One was connected with genuine disequilibria in the basic balance of payments, particularly in the current account. The other was caused by abnormal movements of funds. Of course, the latter were often—but not always!—only a consequence of basic disequilibria. It must be admitted that in such cases speculative movements sometimes had the merit of forcing the right measures of adjustment upon reluctant authorities. But the cost of such reluctant and delayed adjustment was sometimes high.

And the general—and very depressing—conclusion is: *All disequilibrating capital flows among major countries have a tendency of raise the level to inflation in the world.*

VII. DESTABILISING CAPITAL FLOWS AND THE INTERNATIONAL MONETARY SYSTEM

What has blown up disruptive capital flows into such a monster is the combination of two factors: *first,* the enormous increase in the volume of liquid shiftable funds everywhere, with the possibility of rapid shifts from one currency to another through modern communication systems, internationalised banking, and multinational corporations; *second,* the failing confidence in the existing par values of important currencies. The fact that in the recent past the lack of confidence focussed so much on the key currency of the system, and that at the same time there have been so many volatile dollar funds around in the world, produced that torrent of inflationary money flows which finally brought the system of par values down.

I think it has become clear from our recent experiences that we will not see a stable international system in future if we do not succeed in gaining a much better control over such disruptive and inflation-generating capital flows. This raises a host of questions. I will touch only briefly on some of them.

1. Can we hope to eliminate the root causes of such destabilising flows of funds?

This would first of all require that in the future system important currencies would no longer be likely to come under a cloud of mistrust. A vastly *improved adjustment process* would have to guarantee that corrective action would be taken before markets even begin to have doubts about the par value of an important currency. Sanguine people may say that such an improved adjustment process is, after all, what most of the reform is about. But without wanting to appear too pessimistic, I may be permitted a skeptical question: Will "warning points" for corrective action—that will of course become known to the public—or a cumbersome surveillance procedure in a large committee be the appropriate means to prevent any mistrust in par values from arising and to set the markets, i.e., the international trading and financial community, at rest?

To eliminate the root causes would also require a much better *harmonisation of monetary policies* so as to avoid large interest-rate differentials. This is highly desirable but exceedingly difficult to achieve in practice, as no major country at present seems willing to let its monetary policy abdicate its role in domestic demand management.[10]

2. Can at least the vast supply of volatile liquid funds—the potential ammunition for speculative or interest-rate induced flows from one currency to another—be somehow reduced or brought under control?

Politicians usually inveigh against foot-loose Eurodollars and the speculators behind them, who they believe have wilfully overrun our currencies and brought down the fixed parities system. There are proposals to deflate the Eurocurrency markets by reserve requirements, open market policies, or the withdrawal of central bank placements from the market. Some believe in the drying up of excess liquidity through consolidation of the dollar overhang in official reserves. Others again believe the shift of currency reserves out of the dollar into other currencies—the so-called "diversification" of currency reserves—should be subject to strict rules. Without going into details, let me just say this: a) Consolidation of the "overhang" of excess currency reserves, if it is on a purely voluntary basis (as is likely) will not remove those excess funds of central banks that really are volatile and dangerous, nor will it affect non-official dollar holdings at all. b) Control of the Eurocurrency markets is a long way off, in view of the present differences of opinion among the relevant countries. c) A more practicable possibility might be to achieve voluntary agreement among the central banks on their placement of reserves in Eurocurrencies or in secondary reserve currencies, and agreed rules on shifts from one currency to another. This might take 20 billion dollars or more out of the potential supply of volatile funds. But I want to stress that such agreements can probably be attained only on a voluntary basis.

3. Should we envisage defensive control measures against disturbing inflows not only as short-term protection in the interim period but—at least on a standby basis—also in the future system?

This raises fundamental questions of economic philosophy as well as questions of practicability and effectiveness.

I presume everybody would agree that in a market economy freedom of capital movements is a high value in itself and should be respected wherever it does not conflict with more important goals.

There may, however, be situations where the defense of monetary stability is more important than complete freedom of destabilising capital movements—it is a question of choosing the lesser of the two evils. Furthermore, nobody would probably deny that it is the duty of a central bank to control the money supply. Is it not slightly illogical if at a time of necessary restraint banks or the business community were to be allowed under all circumstances to gain free access to central bank money through the back door, i.e. by freely borrowing liquidity in international money markets (which may be distorted by all sorts of foreign action) and converting the proceeds into highpowered money at home?

But these considerations are not meant to justify a carte blanche for capital controls. In particular, I would strongly object to capital controls for protectionist purposes or for the purpose of maintaining an incorrect rate of exchange. I believe

[10] Some lonely voices have suggested to us in Germany that we should adjust our domestic interest rates to whatever level would be required to fend off unwanted inflows from abroad. At the present time, this would mean going down to somewhere between 3 and 5% (as foreigners seem to be prepared to hold DMarks in the Eurocurrency market at even slightly lower rates). This would be tantamount to a complete capitulation to inflation in Germany. We would drive out the devil of inflationary money inflows by invoking the demon of even greater domestic inflation.

that some of the controversy over the principle of capital controls stems from the fact that the defenders of absolute freedom do not sufficiently distinguish between capital controls which in open or covert form pursue protectionist goals, and those controls which are purely a defense against disruptive inflows of liquidity from abroad, and which are in fact nothing but a logical extension of, or supplement to the indispensible regulation of domestic money supply. The role of defensive capital controls will, however, often be severely restrained by their limited effectiveness. It is on the whole possible, according to our experience, to distinguish between "normal" capital movements and irregular and disruptive money flows. But in times of currency unrest and speculation it is very difficult to prevent speculative or interest-rate induced money from coming in through the back door—or rather: through quite a number of back doors.

Thus, as long as currency speculation is not definitely laid to rest, there will always be situations where inflationary money inflows can be only stopped or limited by greater *exchange rate flexibility*.

4. *Assuming that in a parity system disequilibrating capital flows cannot be prevented or significantly reduced: can, and should, they be financed through special credit facilities or "recycled" from the recipient country to the country of origin?*

I have indicated my view on this question already at the beginning of this paper: recycling short-term money flows to the country of origin does not nullify the inflationary effects which have come about with the conversion of the incoming foreign exchange in the recipient country; nor does it undo the expansionary effect on international liquidity. On the other hand, recycling or other semi-automatic financial facilities for offsetting short-term capital flows would recreate ad infinitum the faculty of the deficit country to allow the inflationary capital outflows to continue. Thus they would result in real inflationary "perpetual motion" ("perpetuum mobile").

Let us not forget that the former dollar standard implied such a continuous recycling of incoming dollars back to the United States. It broke down because of the inflationary implications of this process. It would be strange to revive, and even extend to other currencies, this faulty, inflationary system.

5. *And finally: If we were condemned to accept large disequilibrating flows as a price for the inevitable internationalisation of our money system—are there effective possibilities for neutralizing their inflationary effects?*

Here I can offer you first-hand experience, as Germany is the country which has been affected more than any other by destabilising money inflows. Our experience has been the following: inflationary money inflows from abroad can be successfully sterilized insofar as they are directly deposited with the domestic banking system. However, the more effective the central bank is in this respect, the more it is likely that a large part of the inflow will be channelled through the non-bank sector, e.g. through changes in the leads and lags of commercial payments, through multinational corporations (foreign and domestic), and through all kinds of other borrowing operations. We have seen that of the 8 billion dollar inflow of last February and March over half came in via the non-bank sector, and that most of what was originally foreign deposits with German banks has in the meantime been shifted to the non-bank sector. It it very difficult and, at best, a time-consuming process to reduce the inflationary effects on the non-bank sector. Our experience has been that in no case has it been possible to undo the inflationary effects of foreign inflows entirely, not even by the strongest compensatory measures.

Let me draw from this survey of the complex field of destabilising capital flows the following conclusions:

1. It is unlikely that we will meet with quick success in solving any of the complicated problems connected with destabilising capital flows. There is no panacea in sight. We will have to content ourselves with slow, patient progress on as many fronts as possible.

2. We will have to find out by trial and error what combination of monetary policy coordination, more elastic exchange rates, and defensive capital controls will yield the best results—and do the least damage—in taming destabilising capital flows.

3. It is likely that we will have to go on living in the future as well with the "monster" of the Eurocurrency market where at present over one hundred billion dollars of more or less liquid funds are traded, of which an estimated 75 billion are denominated in U.S. dollars, and a sizeable amount also in DMarks.

4. The decisive precondition for a more stable system also in the field of capital movements will be the rehabilitation of the dollar. As long as the dollar is under a cloud, the potential for disturbing flows will be very great. A flight from the dollar

can mobilise incomparably more volatile funds than is the case with any other currency. There are at present about 90 billion dollars in the hands of foreign official authorities (of which about 25 billion dollars are in central banks outside the Group of Ten) and a few dozen billion more in non-official foreign hands. And there is, of course, an additional potential for destabilising flows of untold billions of liquid dollar funds in the hands of Americans themselves.

5. Of the other currencies, only pound sterling and DMarks are in foreign hands in large amount. That does not mean that there cannot be large disequilibrating outflows also out of other currencies—there was one equivalent to over 4 billion dollars from Italy in 1972—but on the whole such outflows from other countries appear manageable from the point of view of the world payments system.

6. I can only stress again my view that there will probably be no definite solution to the devilish problem of destabilising capital flows as long as the dollar is not securely re-established. In the meantime, it is difficult to see how we can dispense with a more elastic exchange rate system in order to hold such flows in check.

VIII. INFLATIONARY CREATION OF INTERNATIONAL LIQUIDITY

International liquidity—the supply of world reserves—has increased explosively since 1970. Countries' reserves in the form of gold, Special Drawing Rights, reserve positions in the Fund, and foreign exchange reserves were equivalent to 78 billion dollars at the beginning of 1970, and 176 billion dollars in March 1973. The dynamic element was *foreign exchange reserves*. They more than trebled during this period from 32 to approximately 115 billion dollars. In comparison, the allocation of 9 billion SDR units over this three-year period appears small.

It is true that a considerable part of this increase in reserves has been concentrated in a few countries, such as Japan, Germany, Switzerland, the Benelux countries, France, Australia, and the oil countries. But most countries have been affected to some extent by the outpouring of dollars. The developing countries as a group, even exluding the oil-producing countries, have experienced a much larger expansion of their reserve holdings since 1970 than had been assumed when it was deciced to create SDRs for the period 1970–1972.

The major source of the tremendous increase in foreign exchange reserves was, of course, the payments deficit of the United States. Of the total increase of over 80 billion dollars, this deficit accounted for 56 billion. The remaining reserve creation came from other sources, in particular reserve creation in the *Eurocurrency market* and the *diversification of currency reserves*. It is estimated that central banks of countries outside the Group of Ten hold the equivalent of at least 20 billion dollars in the Euro-currency markets (not all in dollars, but a growing share in other reserve currencies).

Central banks that invest their dollar reserves in the Eurodollar market are in all likelihood participating in a process of inflationary reserve creation—although they are not directly aware of it. The same is true whenever a central bank moves part of its reserves out of the dollar into other, so-called "secondary" reserve currencies. As a rule, the secondary reserve currency will have to take the dollars into its own reserves so that the total amount of dollar reserves in the world is not changed, while reserves held in the new reserve currency are increased. This process of reserve diversification is apt to increase both international and domestic liquidity in an inflationary way.

So here we have central banks participating in this game of multiple reserve creation, at a time when many of them are complaining about unwanted money inflows and excessive international liquidity! But those that complain are mostly—but not always—other central banks than those that go after the higher interest rates obtainable in the Eurodollar market or the supposed greater security of other reserve currencies.

Is the reserve creation in the form of reserve holdings in national currencies an "imminent" and inevitable feature of the present system? Nothing was laid down in the Articles of the Bretton Woods Agreement about the reserve system and the way in which reserves can or should be held. Nothing has been laid down or agreed upon the Eurocurrency market, apart from the agreement among the central banks of the Group of Ten to limit their reserve holdings in this market. Thus, these developments in the field of reserve creation could be considered an extraneous outgrowth outside the written rules of the system.

But the system does not only consist of the rules laid down in the IMF Agreement. The dollar-based Exchange Reserve Standard—which has grown up over the last 25 years under the force of circumstances and central bank practices—has just as much been part of the international monetary system as the Eurocurrency markets which have been an outgrowth of the last 15 years.

Will these various forces continue to contribute to excessive creation of international liquidity? When the Ministers of the Committee of Twenty met last March in Washington they laid down as one of the requirements of the future system that *"there should be better international management of global liquidity"*.

In the past, some people believed that the mere introduction of the internationally managed SDR (Special Drawing Rights) system would be sufficient to gain better control over international liquidity. This proved, however, to be an illusion. The explosive expansion of international liquidity over the last three years shows that the uncurbed use of *reserve currencies* for reserve accumulation can play havoc with the whole system.

Everybody seems not to agree that there should be better control over this part of international liquidity, too. Everybody has subscribed to the proposal that "the role of reserve currencies should be reduced" (Ministerial Communiqué of the Committee of Twenty). But it is a long road between agreeing on such a principle and implementing it *in practice*. This is sure to be one of the most difficult issues pertaining to the incipient reform of the international monetary system.

IX. INTERNATIONAL MONETARY REFORM AND WORLD INFLATION

What help can we expect from the reform of the international monetary system in the fight against world inflation?

I have tried to show that in the world in which we live any major disequilibrium the basic payments balances, any large disequilibrating capital flows, and any sizeable and wide-spread increase in currency reserves are likely to give the world's inflationary spiral another upward turn. So we should strive for a system which promises to avoid such inflation-generating features as much as possible. What are the prospects for achieving this?

1. A central point of the reform is an improvement in the *adjustment process* in cases of payments imbalances, including a better-functioning exchange rate mechanism. As the Ministers of the Committee of Twenty said in their Communique of last March, the goal should be "to assure timely and effective balance of payments adjustment by both surplus and deficit countries". In other words: large and persistent accumulations of imbalances should be avoided. This is certainly a step in the right direction and takes account of our recent bad experiences. The debate is, however, still wide open on how best to achieve the desired improvement in the adjustment process.

In practice, the crucial point is likely to be the future *exchange rate regime*. This, according to the Ministerial Meeting of the Committee of Twenty, should be based "on *stable but adjustable par values*", and it is was also recognised "that *floating rates* could provide a useful technique in particular situations". These formulas cover a very broad spectrum of exchange rate regimes. The real points at issue will, of course, be: "how stable"? "how adjustable"? and what are "particular situations"? It is likely that the proclaimed readiness to adjust exchange rates quickly, together with the experience of the exchange markets in recent years, will make it nearly impossible for a country to maintain, for any length of time, a parity which the market believes to be unrealistic; or else large destabilising flows of funds will be provoked. Thus the pressure for timely adjustment will be provided mainly by the markets. As concerns the "particular situations" where *floating* is appropriate, I suppose a consensus will emerge that this is applicable in particular as long, and whenever, the key currency of the system is not firmly established as the stabilising anchor of the system.

2. Prompt and early adjustment of payments imbalances and a more elastic exchange rate regime would certainly go some way towards reducing both speculative capital flows and a further build-up of excessive currency reserves. But as long as conversion of currency inflows beyond a certain point, e.g. agreed working balances, is not mandatory *a further uncontrolled expansion of international liquidity cannot be excluded*. Some agreed limitation on the accumulation of currency reserves is required if one really wants to gain better control over global reserve creation. This is not the occasion for discussing the various proposals on this issue that are on the table. But I would like to emphasize that without some stricter rules in this field, the twin inflationary danger of too permissive financing of disequilibria and excessive liquidity creation will persist. Better control over global reserves, which after all is an accepted goal of the reform, would also require some agreed *norms of conduct on the form in which currency reserves are going to be held*, and also on the way in which the reserve-creating power of the *Eurocurrency markets* can be held in check. I fully recognise that in this field the distance between general principles and practical implementation is particularly great. "Political

economy is simple, it's all a matter of execution", Napoleon is reported to have once said. This applies in particular to the control of international liquidity.

In this context *Special Drawing Rights (SDR)* and *gold* have also to be mentioned. The expressed intention of the international community, as represented by the Committee of Twenty, is that the "SDR should become the principle reserve asset of the reformed system". Let me repeat again that this presupposes gaining first better control over reserves in the form of currency holdings. After all, the concept of SDRs was developed on the assumption that the supply of other international reserves would be in chronic short supply. It will be difficult to find a rational basis for the creation of SDRs as long as there is such uncertainty about reserve creation in other forms. In 1969, when the decision on SDR creation for the three-year period 1970 to 1972 was taken, the official assumption in the IMF was that foreign exchange reserves would increase during that period by about 0.5 to 1 billion dollars a year. In fact, the increase reached an annual average of no less than 22½ billion dollars! Finally, I do not think I need to stress that once the Special Drawing Rights come into their own as the principal reserve asset, it will be particularly important that decisions on SDR creation will strictly conform to the principle of global reserve need, and that this need will primarily be measured against the criterion of whether the world economy is suffering from deflation or inflation.

As concerns *gold,* I should like to mention only two things. First, the recent extreme instability of the free market price of gold makes it even less likely than before that the "unfreezing" of gold reserves will be brought about through an increase in the official price of gold—as a measure of value (numéraire) gold has so to speak catapulted itself out of the system. Gold will, however, continue to remain an important part of the central banks' reserves. It is true that at present they are to some extent "frozen" owing to the discrepancy between the official and the free gold price. It would, however, be incorrect to discontinue counting them as reserves until they are "unfrozen". For in case of need a central bank can always obtain a balance-of-payments credit on gold as collateral, at least up to the present official price. This is being demonstrated by the fact that gold can be used in a similar way for settlements in the intra-European payments scheme (the "snake scheme").

3. There remains the critical field of *disequilibrating capital movements.* This has been the object of much soul-searching both in the Committee of Twenty and in other international bodies. We know now all the questions involved, but I doubt whether we know much about the really practicable answers. I have touched on most of the relevant problems earlier in this paper. No panacea has as yet been found for dealing with this crucial problem in a future monetary system. So we may have to continue in the pragmatic manner which has evolved under the pressure of crises until world-wide payments equilibrium and restored confidence in all the major currencies have removed the problem from the critical list. In the period of transition to this better world, floating between the major currency blocks may again be the best—or rather; the least bad—answer to the problem.

X. THE INTERNATIONAL MONETARY SYSTEM SHOULD NOT BE MISUSED AS SCAPEGOAT

In this paper, I have set myself the task of elucidating the contribution of the international monetary system to world-wide inflation. Probably to nobody's surprise, the resulting list of sins has proved to be long. But before concluding my remarks I have to set the record straight.

It would be an exaggeration to put all, or even the main responsibility for world inflation on the now defunct international monetary system. It has certainly very much *facilitated the spreading of inflation* from one country to another; it has also facilitated national inflations by its *permissive system of balance-of-payments financing.* And some of its features, such as autonomous reserve creation and destabilising capital flows, have directly *generated inflation* by themselves

But it is still true that in most cases the larger part of inflation has been "home-made". And it is only fair to add that better domestic stability in all the major countries would have prevented the international system from unfolding all its negative features. I find it important to make this "caveat" because the international monetary system is too often used as a scapegoat or alibi by national governments. In Europe, at least, there is hardly a government today that would not blame a large part of its domestic inflation troubles on the inflationary international environment and the system's mechanism which seemingly make it impossible for a country to achieve stability individually (or to live as an "island of stability in an ocean of inflation"). But that does not, of course, mean that

countries could not achieve more stability if they showed collectively, or at least among a group of them, more strength of purpose and more resistance against inflation at home. Moreover, a country could at least partially shield itself off against imported inflation by making appropriate use of the exchange rate mechanism.

XI. THE EFFECTS OF CHRONIC INFLATION ON THE WORLD MONETARY SYSTEM

My final question is not concerned with the contribution of the international system to inflation, but with the reverse question: *what impact is chronic inflation in the major countries likely to have on the international monetary system?*

A system of fixed parities is based on the assumption that governments, although they may not be able to avoid inflation entirely, retain at least some control so as to keep it within limits. Of course, there will always be "dropouts"—but in such a system they should be the exception and not the rule. Should, however, governments have no longer sufficient control over the rate of inflation then it is difficult to see how they will be able, over the medium term, to keep the development of domestic demand, prices and costs in line with that in other countries. *In such a system of intractable inflation, a regime of fixed parities will be put under severe strain.* Mr. Shultz, the Secretary of the U.S. Treasury, made this point in his statement at the Annual Meeting of the IMF in September 1972: "Any stable and well-functioning international monetary system must rest upon sound policies to promote domestic growth and price stability in the major countries". Or as Mr. E. Bernstein, one of the Founding Fathers of Bretton Woods, put it more bluntly: "It is virtually impossible to operate a system of fixed parities in a world of chronic inflation." Both the willingness to tolerate high inflation and the capacity to fight effectively against inflation differ from country to country. Therefore divergent developments would be inevitable.

All this makes it likely that the future international monetary system, especially its exchange rate regime, will be less determined by any new written rules than by two other factors, i.e. *first*, the development of the U.S. balance of payments and the rehabilitation of the dollar, and *second*, the outcome of the fight against inflation in the major countries.

Both factors point at present in the direction of a continuation of floating between the dollar and the major other industrial countries during an interim period of uncertain duration.

But this is not the end of the story. What will the system look like once the dollar has been restored as a strong currency and the United States has become again, as it was in former times, an anchor of stability for the rest of the world? A system of stable parities, duly reformed, might then be given a new lease of life. And the stable parity system might then serve not as a transmission mechanism for inflation, but instead for stability.

A Proposal for a U.S. Public Development Corporation

(Statement of N. R. Danielian, president, International Economic Policy Association, submitted to the Subcommittee on International Economics of the Joint Economic Committee, July 6, 1973)

As of the end of April 1973, current U.S. liabilities to foreigners amounted to \$91 billion, of which liabilities to foreign official institutions were \$71 billion. Some \$50 billion was owed to Western Europe and \$18 billion to Japan. Part of this vast store of dollar reserves and liquid private dollar holdings is, of course, desired liquidity for the holders; but a large part, especially of the foreign central banks' share, is an excess—an overhang of unwanted funds absorbed in desperate currency support operations—which hinders cooperation in monetary, trade, common defense and other spheres. International monetary stability probably cannot be restored without effective action to "fund" this overhang on a long-term basis. Current headlines confirm the world's concern with just that problem: the stability of the dollar and of the international monetary system.

At every gathering of international financial authorities, demands are made on American officials to establish some kind of convertibility of the dollar into "other" assets. It is not always clear what is meant by "other" assets. Certainly it is known that the United States does not possess enough gold or foreign currencies to convert these liabilities. The dollar, as legal tender in the United States, can buy anything on sight within its domestic jurisdiction, with a few exceptions. Foreigners cannot control U.S. communications companies. Defense-related

technology is under export license. There was a time when foreigners could buy unlimited amounts of wheat, corn and soybeans, but often, instead, protected their domestic markets against U.S. grain. These are now in short supply, and cannot be bought and shipped at will.

Still, there are many other assets, quite apart from goods and service, that are freely available, into which foreign holders can convert their dollars: Real estate, corporate shares—now selling at bargain prices—direct investments in industrial plants, long-term U.S. Government bonds. These are "other" assets which foreigners can acquire without any particular intervention by the U.S. Government.

The reason why these alternate uses of dollars have not become more widely popular abroad is due to a number of cultural, institutional, and governmental restraints. Equity-share ownership is not a widely accepted mode of investment by foreign publics. They prefer short-term debt instruments at high interest rates or gold—something quickly convertible and moveable. The larger holdings are concentrated in banking institutions. Until recently, they, too, have tended to favor high-yield, short-term investments. And in a turbulent foreign exchange market, not only the intrinsic value, but the currency denominations are important, thus causing constant shift of portfolio holdings.

The central banks, which hold the largest share of dollars abroad, are subject to statutory limitations on the use of their reserves. They cannot invest them in corporate securities or real estate. Most cannot invest them in long-term instrumentalities, but must have "liquidity." Since central banks surely now have *excess* liquidity, the reasons why they need to hold all of their reserves in quickly convertible liquid form is another of those historical anachronisms that needs to be modified. There are also exchange controls in many countries which limit the inward and outward flow of capital and require specific governmental approval for many transactions.

All of these factors militate against the normal circular flow of investable funds in the international money markets and their placement into the most productive and useful employment. This means that the United States Government must make a special effort to find an agreed solution to the elimination of the surplus dollar overhang abroad.

One approach to neutralizing this excess foreign liquidity would be a "U.S. Public Development Corporation," established by law as a government corporation empowered to borrow liquid dollar holdings on a long-term basis from foreign central banks, individuals, and institutions, and the IMF. The interest rates would have to be attractive; and a maintenance-of-value guarantee might be desirable, for example, by denominating the Corporation notes in terms of SDR's, or in foreign currencies with the option of SDR conversion under certain conditions.

The proceeds from borrowing excess dollars abroad would be loaned to U.S. municipalities, states, and other agencies, for urban development, housing, schools, transportation, sewage treatment plants, and other needed improvements. Interest rates on such re-loans would approximate those of tax-exempt bonds, and the loans would probably require a guarantee by the governmental authority with jurisdiction over the local borrowing entity. The U.S. Government would, in effect, subsidize the difference between interest received and paid out by the Corporation. States and local jurisdictions would retain planning and control of all projects. Private capital would be assured an appropriate role in the overall development efforts.

This proposal could provide a partial restoration of dollar convertibility and a means of funding the "overhang"; that is, to translate present short-term liabilities into long-term funding. To overcome some of the difficulties mentioned before, U.S. Treasury officials would have to engage in negotiations with foreign central banks, and finance ministers, as they did in the past to place Roosa Bonds in foreign governmental portfolios.

A second purpose of the Public Development Corporation would be to stimulate a greater flow of low-cost capital to meet urgent domestic needs in the public sector; priority for loan requests could well go to areas of high unemployment or special urban problems.

There could be some inflationary effects if the funds available stimulated demand above the levels of unutilized capacity; but many municipal projects now lack the required financing. The effect on interest rates here and abroad is another aspect to be considered; but the process of starting the operation would be gradual, perhaps $2 to $3 billion in the first year, rising to, let us say,

$10 to $15 billion in total. On this basis, the effects on interest rates and on inflation should be quite manageable. In any case, the United States currently is again entering a phase of very tight money which will adversely affect the financing prospects for state and local projects by raising the interest rates they will have to pay.

One obvious question is, why should the United States extend a maintenance-of-value guarantee indirectly through a subsidiary corporation which it is not willing (and under present laws is not allowed) to extend on Treasury obligations? The answer is, it should not—except for substantial offsetting considerations. The United States has done so in the old "Roosa Bonds" (and to some extent vis-a-vis the international monetary institutions); and it does so every time the Federal Reserve Bank of New York borrows foreign currencies through its swap network on behalf of the U.S. Treasury, thereby incurring short-term foreign currency liabilities in order to quell speculative disturbances, in effect a maintenance-of-value arrangement.

Another question is, why should two different objectives be combined, i.e., a solution to the problem of the dollar overhang and the financing of useful local projects at home? The answer is, if the United States is to do the first for international reasons, it might as well serve a useful domestic purpose. The free market will not always allocate funds to public purposes at feasible interest rates for public borrowing—especially in tight money periods. Certainly the overhang of dollars in question would not otherwise end in such commendable uses—the surplus funds are controlled mostly by official foreign institutions, which, as noted above, may not be allowed to invest in the U.S. stock and real estate markets, or in municipal bonds.

The public development corporation arrangement itself must be negotiated among governments and approved by Congress. Such a proposal would be more readily acceptable to the Congress if the proceeds were used for needed local projects. The analogy to the general principle of "revenue sharing" gives added creditility to this political judgment.

It is to be hoped that foreign governments and people, in addition to finding a remunerative placement for their funds, will take pride also in helping solve some of the civic and community problems in the United States—a reverse Marshall Plan, if not in cost, at least in spirit.

Will this project increase the cost to the Federal Government getting the local projects financed? The answer is, not necessarily. There are billions of dollars allocated on a matching grant basis to states and municipalities. Channeling such federal funds into paying the interest differential on funds borrowed abroad through the U.S. Public Development Corporation, in fact, might prove to be a more cost-effective approach for the Federal Government, causing a greater number of projects to be undertaken for a given federal expenditure.

Finally, is this proposal another incursion of government bureaucracy into the realm of private enterprise? One hopes not. The projects contemplated for financing involve major public projects which are usually financed by local and state bond issues—in a developing country receiving aid, they would be considered "infrastructure." Many of them, in time, should be of a self-liquidating nature from taxes or user charges. The projects themselves would be undertaken by competent private entrepreneurs, specialists in the particular sphere, for example, water purification, municipal sewage, urban transportation, or school construction. The funds of the Corporation should also be available to help finance the activities of private companies engaged in solving problems in their specialized fields of activity. In order to decentralize operations, the Corporation might properly work through a network of local banking consortia.

The most important unresolved question is whether the United States should grant maintenance-of-value guarantees on its external obligations, and if so, for what consideration? If other countries agreed to carry their share of common defense costs and to supply a greater share of foreign aid in terms of absolute amounts, if they granted true reciprocity and national treatment to U.S. trade and investments, and if agreement on maintenance of value were the only problem standing in the way, then it might prove well worth considering maintenance-of-value guarantees as a major step toward restoring international monetary cooperation.

Finally, is the idea feasible? IEPA has discussed the proposal or corresponded with a considerable number of the most knowledgeable European public and private bankers about it. Their comments fall broadly into three categories: enthusiastic (especially to the extent that maintenance-of-value guarantees were

involved); positive on the international aspects; neutral or uninformed about the domestic uses of the money borrowed; and skeptical: "either too little and too late or unnecessary, depending on what happens to the dollar."

Since the idea was first advanced, the plight of the dollar has worsened. Thus, with the World Bank and IMF looking forward to a vital fall meeting (where the swollen dollar overhang will be a major agenda item), the concept seems worthy of serious consideration as a politically sensible solution to one segment of a major national and international problem.

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